

Reforming the Tax Treatment of Divorce: Splitting the Benefits of a Split

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I. INTRODUCTION

*Dear Sammy,
Our life together was a financial success, but an artistic
failure.¹ Our marriage is over.*

*Regards,
Becky*

*my
cc: old lawyer*

Whether Becky has grounds for divorce is hardly at issue under the typical no-fault divorce statute.² Becky's terse epistolary farewell omits reference to the subjects of dispute that will soon dominate their new relationship as a divorced couple: the family business; the home; the furniture; and other investments, most of which are not easily divisible. The last thing they are thinking of is the implications of their financial arrangements or their present and future tax liability. As they travel along the path of divorce, the problems that will assail them include the laws governing the taxation of the divorce settlement. The question for Becky, Sammy, and their respective advisors is how to unscramble the assets of the marriage in a way that will lead to a fair division after the tax burdens are imposed. The basic problem in achieving this end is that the price tag of the split-up

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1. *Cf. Bernatschke v. United States*, 364 F.2d 400, 405 (Ct. Cl. 1966) (wife's singing concerts "were artistic successes rather than profitable ventures").

2. *See, e.g., CAL. CIV. CODE* § 4506 (West 1983); *WASH. REV. CODE* § 26.09.030 (1983).

is uncertain because the incidence of income tax on the division of the marital assets under current law is unpredictable.³ The inevitable result is that many separation agreements, which the parties think will settle the financial responsibilities fairly, have unwanted tax consequences.

The purpose of this article is to consider the tax consequences of divorce, particularly those problems relating to property settlements. The tax consequences of alimony and child support are also considered. These problems have a long history that must be reviewed in order to understand both the present law and the current proposals⁴ which were considered by the House Ways and Means Committee during the last session of Congress. Unfortunately, the narrowness of the legislative proposals permits many of the problems to continue; the proposals change only the timing of the problem.

II. PROPERTY DIVISION

A. *No Direct Election Under Current Law*

The act of "splitting the sheets," under current law, may have any one of three disparate results: nontaxable division of assets,⁵ recognition of gain or loss,⁶ or includible⁷/deductible⁸ alimony. Becky and Sammy may come to learn that determining the holder of legal title to property, by either contract wording or presumptions of state law, has more importance in establishing respective tax burdens than either their agreement or the divorce court decree. Will there be a cost at all? If so, to whom? Ultimately, geography governs in determining whether a divorcing couple's tax liabilities remain unchanged in the wake of divorce or whether they have each made money, lost it, or received a deduction.⁹

Under current law, divisions of co-owned property are non-

3. The current rules are often litigated and often prove "a trap for the unwary." H.R. REP. No. 432, 98th Cong., 1st Sess. 191 (1983).

4. H.R. 4170, 98th Cong., 1st Sess. (1983). See *infra* note 87.

5. See *Carrieres v. Commissioner*, 64 T.C. 959, 963 (1975) *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977), *acq.*, 1976-2 C.B. 1; *Wren v. Commissioner*, 24 T.C.M. (CCH) 290 (1965); *Davenport v. Commissioner*, 12 T.C.M. 856 (1953); *Walz v. Commissioner*, 32 B.T.A. 718 (1935).

6. *Davis v. United States*, 370 U.S. 65 (1962).

7. I.R.C. § 71(a)(1) (1982).

8. I.R.C. § 215 (1982); see *Watkins v. Commissioner*, 53 T.C. 349 (1969).

9. See generally *Davis*, 370 U.S. at 71; *Poe v. Seaborn*, 282 U.S. 101 (1930).

taxable.¹⁰ Divisions of separate property are taxable.¹¹ State law often provides a presumption of either separate property or co-ownership of property, but that presumption can be varied by contract.¹² Hence, residents of community property states can elect separate property status resulting in taxable transfers in connection with divorce, and residents of common-law states can elect joint ownership resulting in nontaxable divorce settlements. Thus, if a couple wants a taxable or nontaxable division of property to occur upon divorce, fulfillment of their dream merely requires early planning. For most married taxpayers, tax planning is not done until the divorce; at that time, the tax consequences of property divisions are obscure but final. The need for certainty as to the tax cost of the division is acute. Without this figure, one cannot calculate the value of a property settlement. Yet, the tax law prohibits a direct election of tax consequences by the divorcing couple. To have the chosen tax consequences, the election must not be connected to the divorce.¹³

Although antithetic to true romance, the best divorce for tax purposes is the one that is premeditated and, preferably, one that is planned from the first date. However, even the divorce that is planned on the courthouse steps can afford the participants some options for tax consequences. One example is the selection of taxable (alimony) or nontaxable (child support) support payments. Despite whatever current law allows the parties

10. See Rev. Rul. 81-292, 1981-2 C.B. 158 (division of jointly held property in common law state); Rev. Rul. 76-83, 1976-1 C.B. 213 (division of community property).

11. *Davis*, 370 U.S. 65. A transfer made pursuant to a property division is neither income to the recipient nor deductible by the transferor. *Lambros v. Commissioner*, 459 F.2d 69, 71 (6th Cir. 1972); *Houston v. Commissioner*, 442 F.2d 40, 41 (7th Cir. 1971); *Campbell v. Lake*, 220 F.2d 341 (5th Cir. 1955); *Smith's Estate v. Commissioner*, 208 F.2d 349, 351 (3d Cir. 1953); *Mills v. Commissioner*, 54 T.C. 608, 618 (1970) *aff'd*, 442 F.2d 1149 (10th Cir. 1971); *Thompson v. Commissioner*, 50 T.C. 522, 525 (1968).

12. See, e.g., LA. CIV. CODE ANN. art. 2328 (West Supp. 1983); WASH. REV. CODE § 26.16.120 (1983); but see *Jones v. Commissioner*, 43 T.C.M. (CCH) 1416 (1982) (contract that future earnings are separate property of earner spouse invalid under Texas law).

13. It is arguable, for example, that the transfer of property by gift between spouses shortly before commencement of an action for divorce may be treated as a transfer in exchange for marital rights. In such a case, the original transfer and the divorce are as closely connected as any two steps in the divorce process for purposes of the step-transaction doctrine. The step-transaction doctrine is used by the Commissioner of Internal Revenue to attack the tax consequences of a transaction. Combining a single transfer of property with other transactions (steps) into a single integrated transaction will produce a different tax result. See B. BITTKER & J. EUSTACE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, ¶ 1.05 (1971). The step-transaction doctrine has not been used to challenge property divisions incident to divorce. See generally *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938).

to plan by agreement, tax consequences cannot be specifically elected as such. Such consequences are effects of other unrelated substantive transactions. The choice offered is not between taxable and nontaxable payments, but between alimony¹⁴ and child support,¹⁵ or alimony and property settlement.¹⁶ Becky, who wants a payment to be nontaxable, cannot say so directly. She must style the agreement as child support.¹⁷ On a government challenge to the agreement, the court may find the desired child support payment was, in fact, alimony.¹⁸ The court's decision will produce tax consequences exactly contrary to the careful plans of the divorced couple, by changing a nontaxable and non-deductible payment into a taxable and deductible one. This is so because the question is not whether the payment was intended to be taxable or nontaxable, but whether it is properly termed child support or alimony in law.¹⁹

B. No Safe Harbor

How do you split the pie, if no child is involved? Sammy and Becky will soon learn that property transfers do not provide a safe harbor.²⁰ Assume their only property is 100 shares of stock with a basis of \$100 and a fair market value of \$1,000, which were held for investment for more than a year.²¹ The stock has a potential gain of \$900. Sammy and Becky desire a 50-50 split of property owned at the time of divorce. Becky does not want ali-

14. I.R.C. § 71(a) (1982).

15. I.R.C. § 71(b) (1982).

16. See *Mills v. Commissioner*, 442 F.2d 1149 (10th Cir. 1971); *Bernatschke v. United States*, 364 F.2d 400 (Ct. Cl. 1966); *Schatz v. Commissioner*, 42 T.C.M. (CCH) 292, 296 (1981); *Ryker v. Commissioner*, 33 T.C. 924, 929 (1960). The provisions of section 71 apply to payments made "in recognition of the general obligation to support." Treas. Reg. § 1.71-1(b)(4) (1960). Hence payments not in the nature of support, such as property divisions, are not regulated under the alimony section. See H.R. REP. No. 2333, 77th Cong., 2d Sess. 83-85 (1942).

17. See *Commissioner v. Lester*, 366 U.S. 299 (1961); *Blakey v. Commissioner*, 78 T.C. 963 (1982).

18. *Gilbertson v. Commissioner*, 10 T.C.M. (CCH) 594 (1951).

19. See *Beard v. Commissioner*, 77 T.C. 1275 (1981); *Jackson v. Commissioner*, 54 T.C. 125, 130 (1970); *Harris v. Commissioner*, 51 T.C. 980 (1969) (payments characterized as alimony in decree taxed as child support); *Joslin v. Commissioner*, 52 T.C. 231, 236 (1969), *aff'd*, 424 F.2d 1223 (7th Cir. 1970).

20. *Schatz v. Commissioner*, 42 T.C.M. (CCH) 292, 296 n.10 (1981).

21. The examples used herein assume that the property sold or divided is eligible for capital gains treatment. Such treatment depends on the character of the property transferred. See, e.g., I.R.C. § 1221 (1982) (assets held for investment receive capital gains treatment); see also *infra* note 150.

mony. Sammy has title to the stock which was acquired during the marriage.

Sammy and Becky have two options: either sell the property and divide the cash proceeds, or divide the property itself. Selling the stock avoids untoward division of the tax burden, but at the cost of immediate recognition of gain. If the stock is community property and it is sold,²² the divorced couple share equally the tax burden (\$90 each) and the net proceeds (\$410 each).²³ If it is separate property, Sammy's tax burden is technically increased to \$180, but the after-tax distribution still nets each party \$410. Therefore, title affects the tax burden but not the amount of ultimate proceeds to be divided. Can the obvious defect, the immediate recognition of tax consequences, be deferred without compromising equal division?

The answer is yes if Sammy's stock is community property. Sammy and Becky can each take 50 shares with a basis of \$50. One-half the community basis is allocated to each party.²⁴ Assuming for the purpose of comparison that he and she both immediately sell their shares for \$500, the tax burden and the proceeds are unchanged from the cash division above. Each pays \$90 in tax and nets \$410.²⁵ However, if Sammy's stock is separate property, there is a substantial difference in the amount of net proceeds shared by each party: with the entire tax burden of \$180 paid by Sammy, he nets only \$320, while Becky nets \$500.²⁶ In sum, in a common-law jurisdiction, an equal division of separate property cannot both divide the tax burden fairly and avoid the immediate recognition of gain.

Treatment of the transfer as alimony²⁷ is a possible unin-

22. See I.R.C. §§ 61(a)(3) (1982) (gain from sale of property included in gross income); 1001(a), (c) (recognition and computation of gain).

23. See *infra* p. 446, Table 1 Column A (community property or jointly held property) and Column B (separate property).

24. See *Wren v. Commissioner*, 24 T.C.M. (CCH) 290 (1965). The basis of a divided asset is the percentage of the asset received multiplied by the community's pre-divorce basis in the asset. Rev. Rul. 76-83, 1976-1 C.B. 213; see also *Carrieres v. Commissioner*, 64 T.C. 959 (1975), *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977).

25. See *Carson v. Commissioner*, 37 T.C.M. (CCH) 818, 820 (1978); *Harrah v. Commissioner*, 70 T.C. 735, 748 (1978); *Walz v. Commissioner*, 32 B.T.A. 718, 720 (1935).

26. See *infra* p. 446, Table 1, Column C. See also *Davis*, 370 U.S. at 73; Rev. Rul. 67-221, 1967-2 C.B. 63. The basis of Becky's property is the fair market value at the date of transfer.

27. See *Hayutin v. Commissioner*, 508 F.2d 462 (10th Cir. 1974); *Warnack v. Commissioner*, 71 T.C. 541 (1979), *acq.*, 1979-1 C.B. 1. But see *Riddell v. Guggenheim*, 281 F.2d 836 (9th Cir. 1960) (payments for share of community property not alimony); *Goninen v. Commissioner*, 47 T.C.M. (CCH) 737 (1983); *Dorn v. Commissioner*, 46

tended tax consequence in either a community property³⁸ or

TABLE 1

	A		B		C		D	
	H	W	H	W	H	W	H	W
A. Fair Market Value	\$ 500	\$ 500	\$1,000	\$	\$1,000 ^a	\$500 ^a	\$1,000 ^a	\$500 ^a
B. Less Basis	50	50	100		100	500	100	50
C. Gain	450	450	900		900	0	900	0
D. Capital Gain Deduction	(270)	(270)	(540)		(540)	0	(540)	0
E. Includible in Gross Income	180	180	360		360	0	360	0
F. Tax (assume 50%)	(90)	(90)	(180)		(180)	0	(180)	0
G. Net Proceeds	410	410	410 ^a	410 ^a	320	500	320	500
H. Alimony: (deduction) of income							(500)	500
I. Net of Tax (assume 50%)							(210) ^a	250

^a H distributes half of after-tax proceeds on sale of stock - \$820.

^a H distributes half of the stock to wife, sells remainder

^a H distributes half of the stock to wife, treated as alimony.

^a Alimony (deduction) \$500 Line (H) minus gain Includible in Gross Income \$360 (Line (E)) plus \$70 (50% (Line H - Line E) = \$210.

T.C.M. (CCH) 1545 (1983) (noncontingent payments not to exceed 10 years not treated as alimony); Wells-Lee v. Commissioner, 25 T.C.M. (CCH) 1217 (1966) (payment designated as alimony by the state court nonetheless taxed as property settlement).

28. Ryker v. Commissioner, 33 T.C. 924 (1960) (character of payment determined by surrounding facts and circumstances).

common-law jurisdiction.²⁹ Such treatment is most likely to occur under an equitable apportionment statute which in a common-law jurisdiction³⁰ permits judicial discretion in dividing property owned by Sammy or permits an unequal division of community property.³¹ Under such a statute, Becky's property rights are difficult to evaluate.³² If she receives property based on her need for support as well as her deemed contribution to the family, Sammy may be able to convert the property settlement into alimony³³ despite his agreement with Becky. Furthermore, this result may occur in a community property state in two other ways. First, in the case where the value of Becky's interest in the community is difficult to estimate, the agreed amount of her interest for purposes of property settlement may be disregarded in a future tax proceeding. If her pre-divorce interest is found to be less than she in fact received in the divorce settlement, the amount received in excess of the value of her share of the community may be taxable as alimony³⁴ if it meets the other requirements of section 71 of the Internal Revenue Code ("I.R.C.").³⁵ Second, the same result may occur if the couple elected during their marriage to own all their assets as separate property. In that case, transfers from one spouse to the other may be characterized as alimony. The result is to give Sammy an effective windfall of \$530, and leave Becky with only \$250 net proceeds. This is hardly the result that divorced couples desire,³⁶ but it is a quite possible result under current

29. See *Wright v. Commissioner*, 543 F.2d 593 (7th Cir. 1976); *Bardwell v. Commissioner*, 318 F.2d 786 (10th Cir. 1963); *Schottenstein v. Commissioner*, 75 T.C. 451 (1980), *acq.*, 1981-2 C.B. 2 (periodic payments of "property settlement" taxed as alimony).

30. See, e.g., N.Y. DOM. REL. LAW § 236 (McKinney Supp. 1983-84); OHIO REV. CODE ANN. § 3105.18 (Page 1980).

31. See, e.g., *Taylor v. Campbell*, 335 F.2d 841, 845-46 (5th Cir. 1964); TEX. FAM. CODE ANN. § 3.63 (Vernon Supp. 1982-83).

32. See *Nathan v. Commissioner*, 19 T.C. 865 (1953).

33. *Schottenstein v. Commissioner*, 75 T.C. 451, 463 (1981), *acq.*, 1981-2 C.B. 2 (household and child care services do not aid in accretion to family wealth).

34. *West v. United States*, 332 F. Supp. 1102 (S.D. Tex. 1971), *aff'd*, 477 F.2d 563 (5th Cir. 1973); *Furgatch v. Commissioner*, 74 T.C. 1205 (1980).

35. I.R.C. § 71 (1982) provides that under a decree of divorce, separate maintenance, or support, periodic payments made to a wife in discharge of the husband's legal obligation which exists because of the marital or family relationship are taxable as gross income to the wife.

36. See *Schottenstein*, 75 T.C. at 460 (more than intent required); but *cf.* *Phinney v. Mauk*, 411 F.2d 1196, 1198 (5th Cir. 1969) (intent of parties controls). See also *infra* p. 489, Chart 1.

law.³⁷

III. PROCEDURAL PROBLEMS

A. *The Search for Substance Over Form: The Role of State Law*

One reasonably would expect the divorce decree or separation agreement between the parties to determine the character of the payment as either alimony or property settlement, and in the latter case, to result in its being taxable or nontaxable. This is not the case. It is settled federal tax doctrine that the incidence of taxation does not depend on the mere form or labels³⁸ given by the parties to the transaction, but on the substance³⁹ of the transaction. For Sammy and Becky, the "substance" may not be settled by either agreement or divorce decree, but in a later tax proceeding in which the federal court may redetermine the character of the transaction and its consequent tax burden.⁴⁰

Where federal tax liability turns upon the character of a state-created property interest,⁴¹ the Supreme Court has held that "federal authorities are not bound by the determination made of such property interest by a state trial court."⁴² In *Commissioner v. Estate of Bosch*,⁴³ the ultimate outcome of a federal estate tax liability controversy hinged on a determination under state law of whether a widow's prior release of a general power of appointment under a trust set up by her husband was valid or invalid.⁴⁴ If invalid, she would have retained a general power of appointment over property included in her husband's estate. The property would then qualify for the marital deduction under the federal estate tax law, significantly reducing the tax

37. See *Landa v. Commissioner*, 211 F.2d 46 (D.C. Cir. 1954).

38. *Westbrook v. Commissioner*, 74 T.C. 1357, 1368 (1980) (payment labeled "support" held property division). See *Weiner v. Commissioner*, 61 T.C. 155 (1973); *Broida v. United States*, 40 A.F.T.R.2d (P-H) ¶ 77-5189 (N.D. Ohio 1977); *Jackson v. Commissioner*, 54 T.C. 125, 129-30 (1970).

39. *Taylor v. Campbell*, 335 F.2d 841, 845 (5th Cir. 1964). See *Widmer v. Commissioner*, 75 T.C. 405 (1980); *Newbury v. Commissioner*, 46 T.C. 690 (1966). Cf. *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252, 255 (1939) (in the field of taxation "written documents are not rigidly binding").

40. *Wright v. Commissioner*, 543 F.2d 593 (7th Cir. 1976). See *Beard v. Commissioner*, 77 T.C. 1275 (1981).

41. *Commissioner v. Estate of Bosch*, 387 U.S. 456, 457 (1967).

42. 387 U.S. 456, 457 (1967).

43. 387 U.S. at 456.

44. *Id.* at 458.

burden.⁴⁵ During the pendency of the tax proceeding, a state probate court held the release invalid.⁴⁶

The Tax Court accepted the state court ruling and permitted the deduction.⁴⁷ The court of appeals affirmed.⁴⁸ The issue was whether a federal court, when deciding a federal tax controversy, is bound by a lower state court determination of substantive law, and more specifically, how the federal court shall find state law when there is no decision on point by a state's highest court.⁴⁹ The Supreme Court held that a federal court deciding a federal tax controversy is not bound by a lower state court opinion when the state's highest court had not resolved the issue in question.⁵⁰ The Supreme Court determined that interpretations of state property law by a state's highest court are binding on federal courts under the *Erie* doctrine.⁵¹ The Court, stating that it was applying *Erie*, held: "If there be no decision by that [the state's highest] court then federal authorities must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State."⁵²

Implicit in the *Bosch* holding, according to Justice Douglas' dissent, is the belief that state proceedings "are brought solely to avoid federal taxes."⁵³ The dissent pointed out that the majority in *Bosch* did not require federal courts to determine whether the state court divorce decree purported to be a "declaration of state law,"⁵⁴ or whether it was "merely a judicial stamp placed upon the parties' contractual settlement."⁵⁵ The Supreme Court also rejected the theory that "state trial court adjudications be binding when the judgment is the result of an adversary proceeding in state court."⁵⁶ It follows that a consent judgment, even if the product of arm's-length negotiations, has no precedential value as an exposition of local property law. *A fortiori*,

45. *Id.*

46. *Id.* at 459.

47. *Bosch v. Commissioner*, 43 T.C. 120, 124 (1964), *aff'd*, 363 F.2d 1009 (2d Cir. 1966), *rev'd*, 387 U.S. 456 (1967).

48. 363 F.2d at 1015.

49. *Estate of Bosch*, 387 U.S. at 467 (Douglas, J., dissenting).

50. *Id.* at 457.

51. *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938).

52. *Estate of Bosch*, 387 U.S. at 465.

53. *Id.* at 470 (Douglas, J., dissenting). See also *id.* at 465 (the majority was also concerned about the bringing of state proceedings to avoid federal taxes).

54. *Id.* at 471 (Douglas, J., dissenting).

55. *Id.*

56. *Id.* at 463.

since most divorce decrees are based on separation agreements,⁵⁷ such decrees are of no precedential value at all.

In construing the federal taxing statute in *Bosch*, the Supreme Court looked exclusively to the legislative history surrounding the statute.

[T]he report of the Senate Finance Committee recommending enactment of the marital deduction used very guarded language in referring to the very question involved here. It said that "proper regard," not finality, "should be given to interpretations of the will" by state courts and then only when entered by a court "in a bona fide adversary proceeding."⁵⁸

Noting that federal courts are not always bound to follow lower and intermediate state appellate courts in diversity cases if the federal court is persuaded that the state's highest court would decide otherwise, the Court added, "[i]t follows here then, that when the application of a federal statute is involved, the decision of a state trial court as to an underlying issue of state law would *a fortiori* not be controlling."⁵⁹

In a property settlement, the determination of whether there was a taxable exchange or a nontaxable division of existing property rights between co-owners is determined under state law at the time of the transfer. The tax consequences of the transfer are then determined by federal law.⁶⁰ Since the Commissioner is not a party to the divorce, tax issues and the underlying property issues are not stabilized by the doctrines of *res judicata* or collateral estoppel.⁶¹

Unlike the statute construed in *Bosch*, property settlements, of course, have no legislative context. Although the legislative history of federal alimony taxation indicates that state divorce law is to be subordinated to a unified federal determination of alimony, I.R.C. section 71⁶² does not apply directly to property settlements. Congress left the tax consequences of property settlements dependent on rights created under state law. Determination of gain or loss on transfer is treated as an ordinary com-

57. See *infra* note 282.

58. *Estate of Bosch*, 387 U.S. at 464 (quoting S. REP. No. 1013, Pt. 2., 80th Cong., 2d Sess. 4 (1948)).

59. *Id.* at 465.

60. See *Forbes v. United States*, 472 F. Supp. 840 (D. Mass. 1979).

61. *Estate of Bosch*, 387 U.S. at 463.

62. I.R.C. § 71 (1982). See *supra* note 36.

mercial transaction. I.R.C. section 1001,⁶³ which is not concerned with the regulation of property settlements, but rather with the calculation of gain in ordinary sales or exchanges of property, provides no relevant history.⁶⁴ No other section is applicable specifically to a property settlement incident to divorce.

The application of such reasoning consistent with *Bosch* to the tax liability for divorce-related transfers causes tax planning in divorce to be unduly complex. Neither the basis of the property acquired in a property settlement, nor the fact that it is a property settlement,⁶⁵ as compared to alimony,⁶⁶ is binding on the federal court. It follows that neither the findings of the divorce court nor the separation agreements determine the future tax consequences to the parties. Of course, tax consequences have a substantial effect on the real value of the settlement.⁶⁷ Even the simplest example has an uncertain answer because of the complexity of tax law.⁶⁸

B. Judicial Allocation of the Tax Burden—A Critique

The adversary model for the determination of tax consequences of divorce allows the husband or wife to take a position inconsistent with either a prior separation agreement between the parties or with the court decree.⁶⁹ The injustice caused by post-divorce tax litigation is not the imposition of tax on one of the parties, but the impact of an unforeseeable tax burden on a bargained-for division of assets. In effect, one party to the divorce can avoid his or her obligation under the agreement and use the tax laws as an instrument of avoidance.

At issue is the allocation of the tax burden between two taxpayers who agreed to allocate it in a particular way.⁷⁰ One spouse can unilaterally change the agreement by changing a

63. I.R.C. § 1001 (1982).

64. *Davis*, 370 U.S. at 69.

65. *Riley v. Commissioner*, 649 F.2d 768 (10th Cir. 1981); *Bishop v. Commissioner*, 55 T.C. 720 (1971).

66. *Schatz v. Commissioner*, 42 T.C.M. (CCH) 292 (1981); *Hesse v. Commissioner*, 60 T.C. 685 (1973), *aff'd*, 511 F.2d 1393 (3d Cir. 1975), *cert. denied*, 423 U.S. 834 (1975).

67. *See Newburger v. Commissioner*, 61 T.C. 457 (1974). *See also Newman v. Commissioner*, 33 T.C.M. (CCH) 219 (1974) (wife's alimony reduced on the basis that it was not taxable income).

68. *Beard v. Commissioner*, 77 T.C. 1275 (1981).

69. *Bolza v. Commissioner*, 42 T.C.M. (CCH) 1138 (1981) (contingent payment held property settlement); *Stiles v. Commissioner*, 43 T.C.M. (CCH) 107 (1981).

70. *Cf. Newburger v. Commissioner*, 61 T.C. 457 (1974).

nontaxable transfer to a taxable one,⁷¹ or by changing the basis of transferred property. Changing the apportionment of tax costs in a divorce property settlement often leaves one party with a tax burden and with limited remedies against the party who received a windfall. The singular remedy is the reopening of divorce proceedings in state court, but only if this is permitted under the applicable state law.⁷² This result obtains even though it is clear that the supposed tax consequences of the transaction affected the total amount of the award of property.

One possible way to avoid this injustice is the approach taken in *Commissioner v. Danielson*.⁷³ In *Danielson*, the Third Circuit refused to recharacterize allocations made between the sales price of a business and a covenant not to compete which was executed contemporaneously with the sale. Ordinarily, the sale of a business would result in a capital gain to the seller and would not be deductible to the buyer. However, as in the *Danielson* transaction, the covenant not to compete results in ordinary income to the recipient and a deductible business expense to the payor. The *Danielson* court believed that if it were to restructure the form of the transaction to match its tax substance, the court would be permitting a unilateral reformation of the contract. This reformation would result in unjust enrichment to the reforming party who would be relieved of the tax allocated to him in the contract.⁷⁴ In *Danielson*, the explicit allocation had "no independent basis in fact or arguable relationship with business reality."⁷⁵ Nevertheless, the court upheld the provision for tax purposes absent proof which would negate the provision in a contract action between the parties.⁷⁶ Substance over form was not a sufficient argument to alter the tax consequences of a negotiated agreement. Restructuring by courts on the ground of substance over form would encourage the parties

71. See *Karageorgevitch v. Commissioner*, 38 T.C.M. (CCH) 1003 (1979).

72. *Graham v. Commissioner*, 79 T.C. 415 (1982). Monthly payments for "family" support are taxed to wife despite retroactive amendment to divorce decree designating payments as child support. State court retroactive orders designating child support as alimony or vice versa are generally disregarded for tax purposes by the federal courts. See *Gordon v. Commissioner*, 70 T.C. 525, 530 (1978). Clerical errors corrected retroactively are given effect for tax purposes. *Id.*

73. 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967). Cf. *Schmitz v. Commissioner*, 51 T.C. 306 (1968), *aff'd*, *Thronsdon v. Commissioner*, 457 F.2d 1022 (9th Cir. 1972).

74. *Danielson*, 378 F.2d at 775.

75. *Id.* at 777.

76. *Id.* at 775. See also *Gregory v. Helvering*, 293 U.S. 465 (1935).

to determine the purchase price based on the supposed tax consequences of the transaction, but allow one party to later shift the tax burden to the other in a tax proceeding.⁷⁷ If the reasoning in *Danielson* was applied to divorce agreements, much of the problem with current law would be eliminated.⁷⁸ But the *Danielson* rule, as such, has not been applied to divorce agreements.⁷⁹

C. Towards Divorce Tax Simplification

The uncertainty of divorce-related tax consequences has lead to acute problems for the couple, the government, and the court system. In the first six months of 1982, 481 of the cases docketed in the Tax Court concerned divorce controversies.⁸⁰ A response by the bar and the federal government was inevitable. The Domestic Relations Tax Simplification Task Force of the American Bar Association comprehensively studied the problem and proposed solutions.⁸¹ Some of their recommendations would obviate the *Bosch* problem. The Task Force recommended that parties to a divorce choose their "correlative tax consequences"⁸² by a written agreement incident to divorce. The agreement, binding on the government and the parties to the divorce, would preclude later judicial characterization of a payment as a non-taxable property settlement or a taxable alimony payment. Much of the injustice created by the *Bosch* case would thus be solved by the simple expedient of a direct label. In the case of a property division, the Task Force recommended that nonrecognition of gain or loss be the general rule. The Task Force alternatively recommended that the recognition of gain or loss be

77. *Danielson*, 378 F.2d at 775.

78. See *Harrah v. Commissioner*, 70 T.C. 735, 747 n.6 (1978) (taxpayer who negotiated divorce settlement on the basis of assets belonging to community could not later claim a step-up in basis as if separate assets were transferred).

79. See *White v. United States*, 550 F. Supp. 96, 100 (M.D. Ala. 1982) (followed divorce court designation). But see *Weiner v. Commissioner*, 61 T.C. 155, 159-60 (1973) (Court refused to apply *Danielson* rule in case of apparent overreaching in negotiating separation agreement).

80. American Bar Association's Domestic Relations Tax Simplification Task Force, ABA Section of Taxation, *The "Private Ordering" Concept in Proposals for Simplification of Domestic Relations Tax Law* 3 (Aug. 2, 1982) (hereinafter cited as *The "Private Ordering" Concept*).

81. See American Bar Association's Domestic Relations Tax Simplification Task Force, ABA Section of Taxation, *Preliminary Specification for Simplification, Technical Memorandum* (May 17, 1981) (hereinafter cited as *Technical Memorandum*).

82. *Id.* at 2.

elective. As under current law, in lieu of agreement, the federal tax liability would be determined by a federal standard, albeit a considerably more simplified standard.⁸³

Congress, having studied the Task Force recommendations, is likely to pass a bill to reform the taxation incidental upon divorce in the current or next session. Congress' proposed bill would apply to marital property transfers⁸⁴ which occur during a viable marriage, and transfers incident to divorce.⁸⁵ Current law would continue to apply to premarital transfers. The bill,⁸⁶ originally introduced in June 1983, was amended and combined with other tax legislation, and reported favorably by the House Ways and Means Committee⁸⁷ on October 20, 1983. Under the bill, parties may agree that a payment, which would otherwise qualify as alimony, would neither be included in the gross income of the recipient, nor be deductible to the payor.⁸⁸ Unlike the Task Force proposal, neither child support nor property settlements under Congress' bill can be designated as alimony (includible-deductible) by agreement. Furthermore, under Congress' bill the recognition or nonrecognition of gain or loss and, therefore, the tax consequences of property settlement, cannot be altered by agreement. The private ordering concept incorporated in Congress' bill does not offer the flexibility of the Task Force proposal. No purpose is apparently served by denying the parties to divorce the right to agree to the apportionment of the tax burden as well as the other economic consequences of their marital dissolution. Failure to agree does not affect the parties to an equal degree.

83. *Id.* at 11. *See id.* at app. III.

84. *See* H.R. 4170, 98th Cong., 1st Sess. § 422 (1983) (adds I.R.C. § 1041(a)(1)).

85. *Id.*

86. H.R. 3475, 98th Cong., 1st Sess. (1983). The provisions concerning divorce were amended and combined with more controversial measures concerning industrial development bonds.

87. H.R. 4170, 98th Cong., 1st Sess. (1983). On November 17, 1983, the House voted to defeat the rule on H.R. 4170. Thus the bill was not brought to the floor prior to adjournment for the year. It is expected that the bill will be reconsidered during the second session of the 98th Congress. 70 TAXES ON PARADE (CCH), No. 33, pt. 1 at 1 (Nov. 22, 1983).

88. H.R. 4170, 98th Cong., 1st Sess. (1983) (§ 423 adds I.R.C. § 71(b)(1)(B)).

IV. THE THREE-WAY CONFLICT AMONG THE SUBSTANTIVE ISSUES OF FEDERAL TAX LAW, STATE PROPERTY LAW, AND STATE DIVORCE LAWS

A. *The Davis Rule*

Property settlement is further complicated under current law because of substantive problems relating to state law presented by the *Davis* case. In 1962, the Supreme Court, in *United States v. Davis*,⁸⁹ held that the husband's transfer of appreciated stock to his wife in settlement of her statutory claim⁹⁰ to his property in a common-law state was a taxable event. Mr. Davis was taxed as if he had sold the stock for cash and used the cash to pay off his wife's claim. The market value of the property transferred became Mrs. Davis' basis in the property received.⁹¹ Under government practice, the exchange of property settlement of marital rights was not treated as a taxable event for the wife.⁹² Since the property transferred was appreciated stock, Davis realized taxable gain to the extent of the "excess of the amount realized over the adjusted basis."⁹³ The "amount realized" is defined as the "sum of any money received plus the fair market value of the property received."⁹⁴ The "property" received by Davis was his wife's inchoate marital rights (similar to dower) which attached on divorce or death.⁹⁵ The value of those rights was determined under rules governing ordinary arm's-length commercial transactions. In such a case, the two sides of the bargain are presumed equal.⁹⁶ The Court found that the wife's right to a portion of the couple's accumulated property did not vest until the death of her husband or divorce. Therefore, the Court did not find that such an interest was equivalent to the co-ownership of spouses in community property states. In a community property state, such an interest vests from its acquisition.⁹⁷ One may well look to com-

89. 370 U.S. 65 (1962).

90. *See id.* at 72.

91. *Davis*, 370 U.S. at 73 n.7.

92. Rev. Rul. 67-221, 1967-2 C.B. 63.

93. *Davis*, 370 U.S. at 72.

94. I.R.C. § 1001(b) (1982).

95. *Davis*, 370 U.S. at 70.

96. *See Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 189 (Ct. Cl. 1954); *Davis*, 370 U.S. at 72.

97. For example, property with a community basis of \$15,000 is divided 60/40. The basis of the property received will be apportioned as follows: \$9,000 (\$15,000 x 60%) and

munity property as the solution to the tax problems of dividing assets upon divorce. But even in a community property state, the economics of the split do not determine whether it is equal for tax purposes.

A property division in a community property state is usually a formal recognition of a right that was vested in the recipient spouse prior to the formal division.⁹⁸ Thus, the transfer of property from community ownership to separate ownership by the husband and the wife is nontaxable so long as the division is of equal value.⁹⁹ The same result occurs in divisions of jointly held property in common-law states. Unlike *Davis*, where the transfer of title was also a transfer of substantive rights of ownership, under community property law the transfer of the stock is merely formal changing of title: the wife owns one-half of the stock before and after the transfer.¹⁰⁰ Commonly, however, community property consists of a single or dominant asset that cannot be divided easily, such as a dwelling.¹⁰¹

Further, the fact that each party to a property settlement receives an equal amount of property does not necessarily ensure a tax-free division.¹⁰² The exchange of an interest in community property for an equal amount of separate property will result in a taxable transaction, in whole or in part.¹⁰³ The amount of gain recognized is affected by the proportion of community property received.¹⁰⁴ If no community property is received, then the realized gain equals one-half of the fair market value of the asset at the date of transfer, less one-half of the community's pre-divorce

\$6,000 (\$15,000 x 40%). The basis remains unchanged. Rev. Rul. 76-83, 1976-1 C.B. 213. See *Wren v. Commissioner*, 24 T.C.M. (CCH) 290 (1965).

98. See Rev. Rul. 56-437, 1956-2 C.B. 507.

99. *Carson v. Commissioner*, 37 T.C.M. (CCH) 818 (1978) (mathematical certainty is not required in nontaxable divisions: 46.2/53.8 split of community property not taxable); *Harrah v. Commissioner*, 45 T.C.M. (CCH) 187 (1982); *Walz v. Commissioner*, 32 B.T.A. 718 (1935). See also Rev. Rul. 81-292, 1981-2 C.B. 158 (division of jointly held property in common-law state is not a taxable event).

100. State statutes do not require an in-kind equal division of community property. See, e.g., CAL. CIV. CODE § 4800 (West 1983).

101. See *Carrieres v. Commissioner*, 64 T.C. 959 (1975) (community owned business). Virgil M. Everhart of Central City, Kentucky, literally chopping his house in half to give his wife an "equal property settlement," was stopped by judicial action. N.Y. Times, Jan. 21, 1983, at A 10, col. 4.

102. *Carrieres*, 64 T.C. 959 (1975).

103. But see Rev. Rul. 76-83, 1976-1 C.B. 213 (\$516 of separate property exchanged in a \$300,000 division held not taxable).

104. *Carrieres*, 64 T.C. at 964.

basis in the asset.¹⁰⁵ Where Sammy receives the dominant community asset and gives separate property solely in exchange to compensate Becky for her interest in the community property,¹⁰⁶ a *Davis* gain will result.¹⁰⁷ For example, if Sammy receives all of the community property valued at \$100, with a basis of \$50, and Becky receives Sammy's separate property valued at \$50 (equal to her one-half interest in the community property), Becky will be treated as if she had sold her community interest.¹⁰⁸ Becky's realized gain is \$25. Sammy acquires a partial step-up in basis equal to one-half the fair market value of the asset.¹⁰⁹ Sammy's basis in the former community property asset is now \$75 (one-half of the community basis (\$25) plus one-half the fair market value of the asset at date of transfer (\$50)).¹¹⁰

B. Application of the Davis Rule to Community Property States

1. Both Community and Separate Property Are Exchanged

If both community and separate property are exchanged, then a hybrid rule results. Sammy and Becky own 100 shares of a family corporation (fair market value \$100, basis \$40), and \$30 in a community checking account. Becky, under a court decree, transfers her one-half interest in the stock to Sammy so that he is the sole owner of the business. Sammy transfers his interest in the community checking account to Becky and, in addition, pays her \$35 from his separate property. Becky realizes a gain of \$30 on the transfer. Under similar facts, the Tax Court held in *Carrieres v. Commissioner*¹¹¹ that the wife only recognized that pro-

105. *Cf. Long v. Commissioner*, 173 F.2d 471 (5th Cir.), *cert. denied*, 338 U.S. 818 (1949); *Rouse v. Commissioner*, 159 F.2d 706 (5th Cir. 1947); *Johnson v. United States*, 135 F.2d 125 (9th Cir. 1943); I.R.C. § 1012 (1982).

106. *Walz v. Commissioner*, 32 B.T.A. 718 (1935).

107. *United States v. Davis*, 370 U.S. 65 (1962).

108. *Siewert v. Commissioner*, 72 T.C. 326, 333 (1979); *Conner v. Commissioner*, 34 T.C.M. (CCH) 1043 (1975); *Showalter v. Commissioner*, 33 T.C.M. (CCH) 192, 195 (1974); *Edwards v. Commissioner*, 22 T.C. 65, 69 (1954). *Cf. Hornback v. United States*, 298 F. Supp. 977 (W.D. Mo. 1969) (jointly held property exchanged for recipient's note held taxable).

109. *Carrieres*, 64 T.C. at 965.

110. *Id.* Where wife received more than half the jointly held property, transferor husband recognized gain equal to the amount of excess joint property because wife had exchanged marital rights therefore. Rev. Rul. 74-347, 1974-2 C.B. 26. *See also supra* note 34 and accompanying text.

111. 64 T.C. 959 (1975), *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977).

portion of the gain which "the separate property received in the exchange bears to the total property received."¹¹² Applying *Carrieres* to Sammy and Becky's division, Becky would recognize a taxable gain of \$21.¹¹³ If there had been sufficient community property available to divide equally, no gain would have been recognized on the transfer. The use of some "separate cash to purchase part of the community"¹¹⁴ does not remove the protection of the "nonrecognition principle to the extent of the value of the community property retained"¹¹⁵ in the division. "Otherwise, there would be introduced a 'cliff effect' under which the use of even \$1 of separate property to remedy a disparity in the division of community property would render the nonrecognition principle inapplicable."¹¹⁶ Since part of the transfer is in substance a "purchase and sale transaction"¹¹⁷ rather than a simple division, to the extent that separate property is used to make the division even the hybrid rule developed by Judge Hall in the *Carrieres* case limits the recognition of gain.¹¹⁸ It is not that the gain is recognized to the full extent of the separate property received, but rather that the presence of separate property is weighted against the community property received in calculating gain.¹¹⁹

2. *Equitable Apportionment—Dodging Davis*

Courts have tried to avoid the application of *Davis* where the division of assets has been approximately equal,¹²⁰ or the application of the *Davis* principle would not benefit either

112. *Id.* at 966-67.

113. \$35 of Sammy's separate property plus the community checking account (\$30) equals \$65 of total property received by Becky. After deducting one-half of the community basis (\$20), Becky's realized gain is \$30. Under *Carrieres*, Becky's realized gain is \$16.

114. *Carrieres*, 64 T.C. at 965. A loan is treated as separate property. Where the proceeds of a loan are used to buy out a spousal interest in community property, the exchange of separate property (the proceeds of the loan) for community property is a taxable event. *Siewert v. Commissioner*, 72 T.C. 326 (1979). Compare *Gerlach v. Commissioner*, 55 T.C. 156 (1970) (separate cash exchanged for community interest) with *Davenport v. Commissioner*, 12 T.C.M. (CCH) 856 (1953) (community cash exchanged for other community property).

115. *Carrieres*, 64 T.C. at 965.

116. *Id.*

117. *Id.*

118. *Id.* at 966.

119. *Id.*

120. *Collins v. Commissioner*, 412 F.2d 211 (10th Cir. 1969); *Imel v. United States*, 375 F. Supp. 1102 (D. Colo. 1973), *aff'd*, 523 F.2d 853 (10th Cir. 1975).

spouse.¹²¹ This generally occurs in property divisions pursuant to an equitable apportionment statute in common-law states. Unlike community property statutes which clearly distinguish between separate and community property from the moment of acquisition, equitable apportionment statutes often follow common-law title to property until apportionment rights attach at the time of divorce.¹²² Whether such a right is a form of co-ownership equivalent to community property, or a lien against property owned by one's spouse, is a matter of state law.¹²³ The *Davis* principle was only applied in the latter case. However, the equitable apportionment doctrine has relevancy to the community property law where the doctrine of equitable apportionment has been incorporated into the substantive law of community property states.¹²⁴ The consequent transfers of community property in unequal amounts trigger gain to the transferor spouse unless an exception to the *Davis* principle is found.¹²⁵

Federal courts determining a tax controversy relating to property division have tried to avoid the application of *Davis* where the highest state court held the wife's rights under an equitable apportionment statute were similar to community property rights,¹²⁶ or where the state divorce court awarded property on the assumption that the division was not a taxable event.¹²⁷ The Tenth Circuit and the Tax Court travel along different roads to come to a nonrecognition result in marital property transfers occurring in common-law states.

The Tenth Circuit took a co-ownership approach in *Collins v. Commissioner*.¹²⁸ Based on a decision of the highest state court that the wife had a "species of common ownership"¹²⁹ which vested prior to the transfer of separate property, the Tenth Circuit held—despite a *Davis*-like fact situation—that

121. See, e.g., *Cook v. Commissioner*, 80 T.C. 512 (1983).

122. See, e.g., N.Y. DOM. REL. LAW § 236 (McKinney Supp. 1983-84).

123. See *Davis*, 370 U.S. at 70-71; *Estate of Gamble v. Commissioner*, 69 T.C. 942 (1978).

124. See, e.g., WASH. REV. CODE § 26.09.080 (1983); TEX. FAM. CODE ANN. § 3.63 (Vernon Supp. 1982-83).

125. *Taylor v. Campbell*, 335 F.2d 841 (5th Cir. 1964); *Stevens v. Commissioner*, 44 T.C.M. (CCH) 220 (1982).

126. See, e.g., *Collins v. Commissioner*, 412 F.2d 211 (10th Cir. 1969).

127. *Cook v. Commissioner*, 80 T.C. 512 (1983).

128. 412 F.2d 211 (10th Cir. 1969).

129. *Id.* at 212 (quoting *Collins v. Oklahoma Tax Comm'r*, 446 P.2d 290, 295 (Okla. 1968)). But see *Wallace v. United States*, 439 F.2d 757 (8th Cir. 1971) (Iowa statute).

the transfer from husband to wife did not trigger gain.¹³⁰ The *Collins* court stated that once the state's highest court interpreted state property law, there was "no need to search state law for indications of other factors that might signify the nature of the wife's property interest."¹³¹ In a later case, *Imel v. United States*,¹³² the district court reiterated the *Collins* holding that co-ownership may exist under state law regardless of descendable rights and rights of management which may or may not exist in the co-owner.¹³³ It followed that there was no settlement of a claim with appreciated property. In contrast to *Davis*, the transfer merely affected a division of property between the two co-owners on which gain or loss was not recognized.

When the Tenth Circuit construed a Kansas statute in *Wiles v. Commissioner*,¹³⁴ the court made clear that its co-ownership theory was grounded on state decision and not a statute. Although the equitable distribution statute interpreted in *Collins* was based on the Kansas model, a property division pursuant to the original Kansas statute was held by the Tenth Circuit to result in a *Davis* gain.¹³⁵ In the absence of a decision by the state's highest court determining property rights, a federal court decided that a tax case is not bound by lower state court decisions.¹³⁶ Thus, *Davis* is still the general principle in transfers of separate property or unequal portions of community property.

In an effort to avoid gain recognition, state courts have based their award of property on grounds that would avoid the consequences of *Davis*. This reasoning was followed by the Tax Court in *Cook v. Commissioner*,¹³⁷ in the face of a ruling by Connecticut's highest court in *Thomas v. Thomas*¹³⁸ that a wife's rights under the equitable apportionment statute did not give her a species of co-ownership. Nevertheless, a transfer of property owned by a husband was held to be a nontaxable division.¹³⁹

130. *Collins*, 412 F.2d at 212.

131. *Id.*

132. 375 F. Supp. 1102 (D. Colo. 1974), *aff'd*, 523 F.2d 853 (10th Cir. 1975).

133. *Id.* at 1112.

134. 499 F.2d 255, 258 (10th Cir.), *cert. denied*, 419 U.S. 996 (1974). *Davis* "did not establish a federal standard as to the nature of pre-transfer rights in the transferred property." *Imel*, 523 F.2d at 856.

135. *Wiles*, 499 F.2d at 258.

136. *See Commissioner v. Estate of Bosch*, 387 U.S. 456, 457 (1967).

137. 80 T.C. 512 (1983).

138. 159 Conn. 477, 271 A.2d 62 (1970).

139. *Cook*, 80 T.C. at 528.

In *Cook*, the husband had title to property which had appreciated an amount exceeding one million dollars during their thirty-three-year marriage.¹⁴⁰ Because of his wife's desire to keep the property in the family, the high basis would not benefit her. Although the decree stated no reason for the transfer, the trial judge testified that he felt the property (Proctor and Gamble stock and family-owned real estate) rightfully belonged to the wife because it was given to the husband by the wife¹⁴¹ (the former Sheila Gamble) and her family in recognition of their marriage. Divorce was compared to the breach of the marriage contract and transfer equivalent to the remedy of rescission.¹⁴² By searching the grounds for the decision, the Tax Court created a new path around *Davis* by treating the divorce as the termination of an ordinary commercial contract.¹⁴³

It is ironic that equal divisions of marital property in common-law states are not taxed because they are analogous to community property divisions. Yet, equal divisions in community property states are taxed under *Davis* because the source of the transfer is separate property. There is little doubt that the application of the *Davis* case to property divisions is one of the great tangles of the I.R.C., state statutes, and developing case law. The inequity of one party to a divorce bearing the entire tax burden and the inability to forecast accurately whether *Davis* applies to a property division have created pressure to overturn the *Davis* rule.

3. Triggering Income—The Basis Principles

Davis has been criticized for two reasons. First, income is triggered at the time of a divorce, a time when liquidity is usually strained. Second, variations in local law lead to disparate tax results for substantially comparable transactions occurring in different states. Both problems need to be addressed, but unfortunately, only the former problem is eliminated by the Task Force proposal or the bill.

The *Davis* case has been criticized on the grounds that

140. *Id.* at 513.

141. *Id.* at 517.

142. *Id.* at 527-28.

143. *Cf. Beard v. Commissioner*, 77 T.C. 1275 (1981) (settlement predicated on a partnership theory so periodic payments were capital in nature and not alimony. If payments are found to be capital in nature, then the quid pro quo of surrendered property rights is but one factor to consider.)

"divorce is simply an inappropriate time for triggering a gain implicit in appreciated property"¹⁴⁴ and that the *Davis* rule tends to exacerbate liquidity problems.¹⁴⁵ Where economic circumstances force the wife to sell her share of marital assets, the *Davis* rule normally precludes gain recognition because the wife's basis in the property is its fair market value.¹⁴⁶ Critics of *Davis* propose that no gain or loss be recognized on transfer.¹⁴⁷ Hence, the wife will have a carry-over basis in the asset received.¹⁴⁸ The gain implicit in the asset will be recognized by the wife upon the sale.¹⁴⁹ The net effect of the proposed change is that the tax liability shifts from the husband to the wife.

The problem with *Davis* lies in the basis principles rather than in the recognition principles. The injustice of the *Davis* case comes not in the recognition of gain by the transferor rather than the transferee, but in the disparity of the basis of the property that will or will not produce the gain.¹⁵⁰ By shifting low- or high-basis assets, the couple can determine which of them will bear the bulk of the tax burden. The tax burden on the appreciation of property acquired during marriage may still be borne by one side despite reversal of *Davis*.

144. *Technical Memorandum*, *supra* note 81, at 2.

145. *Id.*

146. *Davis*, 370 U.S. at 73.

147. *Technical Memorandum*, *supra* note 81, at 5-7; H.R. REP. No. 432, 98th Cong., 1st Sess. 192 (1983).

148. In an equal division of jointly held or community property, the assets received by each party retain their pre-divorce basis and holding period. Rev. Rul. 81-292, 1981-2 C.B. 158, 159. See *Beth W. Corp. v. United States*, 350 F. Supp. 1190 (S.D. Fla. 1972) *aff'd mem.*, 481 F.2d 1401 (5th Cir. 1973), *cert. denied*, 415 U.S. 916 (1974); H.R. REP. No. 432, 98th Cong., 1st Sess. 192 (1983).

149. See Rev. Rul. 81-292, 1981-2 C.B. 158, 159.

150. Tax characteristics other than basis also affect the economic value of property received in a divorce settlement. Compare I.R.C. § 1221 (1982) (capital assets); I.R.C. § 1231 (1982) (trade or business assets; conversions) with I.R.C. § 47 (1982) (recapture of investment tax credits); I.R.C. § 1239 (1982) (gain recognized on transfer of depreciable property between spouses prior to interlocutory decree of divorce ineligible for capital gain rates. See Treas. Reg. § 1.1239-1(c)(1) (1978)); I.R.C. § 1245 (1983) (post-1961 depreciation recapture); I.R.C. § 1250 (1983) (post-1963 depreciation recapture on limited types of real property transfers). If the former sections are applicable to the gain on the sale of the property received in the divorce settlement, the assets may be eligible for favorable tax rates. Application of the latter sections causes gain to be taxed at the much higher ordinary income rates. I.R.C. § 306 (1982) (preferred stock disposition); I.R.C. § 341 (1982) (collapsible corporation stock); I.R.C. § 751 (1982) (partnership interest). See also I.R.C. § 121 (1982) (gain from sale of principal residence by taxpayer, aged 55 or over tax exempt up to \$125,000, \$62,500 for married filing separate return); I.R.C. § 1034 (1982) (nonrecognition of gain on sale of principal residence if replaced within two years). Recognition of a loss is limited. See *infra* text accompanying note 186.

To illustrate how this can arise, suppose Sammy owns two assets, each worth \$100. The basis of stock *A* is \$10 and the basis of stock *B* is \$40. Under the *Davis* rule, the transfer of stock *A* to Becky on divorce would trigger a gain recognition to Sammy of \$90 at a tax cost of \$18. However, if instead he transferred stock *B* to Becky, his gain would be only \$60. In either case, Becky would take the asset at fair market value with a basis of \$100.¹⁵¹ On its sale, she would recognize no gain. Reversing the *Davis* rule still would not necessarily make the tax burden equal between the parties because, under this example, for instance, Becky would bear the tax cost of \$18 and net \$82 upon divorce. The carry-over basis principles¹⁵² apparently allow an even split to come out uneven upon the sale of the asset. A change in the *Davis* principles should be aimed at compensation for the unequal basis and other tax characteristics of property acquired in the dissolution of a marriage. Where two assets worth \$100 have bases of \$10 and \$90, respectively, equality of tax attributes may in theory be achieved if the bases of the properties are aggregated and reapportioned in accordance with their fair market value. The division would result in each asset having a basis of \$50 and an inherent gain of \$50. A way to achieve this result is to permit the parties to agree to a nontaxable cash payment equalizing the anticipated amounts of tax liability which eventually will be recognized upon sale of the property. Yet, such payment without statutory sanction may be itself taxable under the theory that the spouse making the equalization payment is in effect paying the obligation of the recipient. Under *Old Colony Trust*,¹⁵³ this results in additional alimony

151. See *St. Joseph Bank & Trust Co. v. United States*, 716 F.2d 1180, 1185 (7th Cir. 1983).

152. Rev. Rul. 81-292, 1981-2 C.B. 158, 159 (jointly held property); Rev. Rul. 76-83, 1976-1 C.B. 213 (community property); see *Beth W. Corp v. United States*, 350 F. Supp. 1190, 1192 (S.D. Fla. 1972), *aff'd mem.*, 481 F.2d 1401 (5th Cir. 1973), *cert. denied*, 415 U.S. 916 (1974).

153. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) (employer's payment of tax on salaries is taxable income to employee). See *Mahana v. United States*, 88 F. Supp. 285 (Ct. Cl. 1950), *cert. denied*, 339 U.S. 978, *reh'g denied*, 340 U.S. 847 (1950) (payment of wife's tax on guaranteed trust yield held alimony); *Neeman v. Commissioner*, 13 T.C. 397 (1949), *aff'd*, 200 F.2d 560 (2d Cir. 1952), *cert. denied*, 345 U.S. 956 (1953). One might argue under current law that a single payment in the divorce context would be nontaxable alimony. Under current law, a single payment is not treated as periodic and hence does not qualify as alimony under § 71. Under the proposals to amend § 71, the couple could stipulate that the payment is not income to the recipient nor deductible by the payor. See H.R. 4170, 98th Cong., 1st Sess. § 423(a) (1983) (amends I.R.C. § 71(a) (1982)).

income to the recipient.

A second alternative solution to the hardship of gain recognition is to permit gain to be recognized in installments over a period of years if the *Davis* rule is applied to a divorce transfer.¹⁵⁴

V. LEGISLATIVE PROPOSALS TO CHANGE THE TAXATION OF DIVORCE

Congress is considering substantial amendments to the I.R.C. regarding taxation of divorce. The Tax Reform Act of 1983¹⁵⁵ (hereinafter "bill") currently under consideration would for the first time regulate property division incident to divorce and significantly change the alimony provisions of the I.R.C. The bill is based in large part on the legislative proposals made by the Task Force to change the taxation of divorce.

A. *Property Division—The Demise of Davis*

A primary goal of the bill is to overturn the *Davis* rule which triggers gain to the transferor upon divorce.¹⁵⁶ Under the bill, all transfers of property related to divorce are treated as nontaxable divisions of property.¹⁵⁷ The nonrecognition rule applies whether the division is of jointly held property or separate property, and whether the division is in equal or unequal shares. The basis to the recipient is the same as that of the transferor prior to the transfer.¹⁵⁸ The recipient of the transfer is denied a step-up (or step-down) in basis.¹⁵⁹ Its mechanical application excludes any election to choose recognition upon exchange if so desired.

In contrast to the bill, the Task Force proposed that if both

154. Cf. I.R.C. § 6166 (1982) (estate tax extension where estate included closely held business interest); I.R.C. § 402(e) (1982) (formula for favorable tax rates on portion of lump sum distribution).

155. H.R. 4170, 98th Cong., 1st Sess. (1983).

156. See H.R. REP. NO. 432, 98th Cong., 1st Sess. 191-92 (1983).

157. H.R. 4170, 98th Cong., 1st Sess., § 422(a) (1983) (adds I.R.C. § 1041(a)). Transfers are treated as gifts of property. *Id.* at § 422(a) (adds I.R.C. § 1041(b)(1)).

158. *Id.* at § 422(a) (adds I.R.C. § 1041(b)(2)).

159. *Id.* at § 422(a). The bill applies to property transferred between spouses or between former spouses if the transfer is incident to divorce. H.R. 4170, 98th Cong., 1st Sess. § 422(a) (1983) (adds I.R.C. § 1041(a)) (annulment not mentioned in bill). Nonrecognition rules do not apply to antenuptial agreements. *Id.* See *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812 (2d Cir. 1947) (release of marital rights in exchange for property held taxable).

parties agree in writing, the couple should be permitted to "elect out" of the nonrecognition provision. The election would be similar to that now allowed under I.R.C. section 453(d), under which a taxpayer can avoid installment sale treatment under certain conditions.¹⁶⁰ Under the Task Force proposal, the couple may choose recognition of gain or loss to the transferor of property and a fair market value basis to the recipient of the property.¹⁶¹ However, under the Task Force proposal, the election must cover all property divided between the spouses, and in the absence of an agreement the nonrecognition rules embodied in the bill apply automatically.¹⁶²

The mechanical application of the nonrecognition rules under the bill does not have the inherent equity of the direct election of tax treatment by the parties. Assuming a spouse receives property without any tax burden, that portion of property the spouse receives should theoretically be valued more than a portion burdened with potential gain recognition. The nonrecognition rule proposed by the Task Force and the bill will superficially produce a fair division of the tax burden. However, a closer analysis reveals that the problems of *Davis* linger.

If only one spouse transfers property in the division, the bill's basis principle operates in a manner analogous to the gift tax basis¹⁶³ where (with certain adjustments not applicable to divorce basis) the donee takes the donor's basis in the gift. If each spouse transfers property, however, application of the gift basis analogy becomes strained. The transaction is more closely analogous, for tax purposes, to a sale than to a gift.¹⁶⁴ Unlike the typical nonrecognition transaction involving an exchange where gain or loss is frozen in the taxpayer's basis in newly acquired property,¹⁶⁵ under the bill the transferor's basis is grafted onto the property and the inherent gain or loss travels with the property to its new owner.

160. *Technical Memorandum*, *supra* note 81, at 11.

161. *Id.*

162. *Id.*

163. I.R.C. § 1015 (1982).

164. H.R. 4170, 98th Cong., 1st Sess. § 422 (1983) (adds I.R.C. § 1041(b)(2)). Unlike the gift basis rules under I.R.C. § 1015 (1982), the recipient spouse takes transferor's basis whether transferred property is appreciated or depreciated. Thus, the basis rules do not impede recognition by recipient spouse. H. R. REP. No. 432, 98th Cong., 1st Sess. 192 (1983).

165. *See, e.g.*, I.R.C. §§ 358(a)(1), 1031(d), 1033(b) (1982).

The basis principle¹⁶⁶ operates in a peculiar way when applied to reciprocal transfers between husband and wife. Assume now that Sammy and Becky each have separate property. Sammy owns 100 shares of X stock, basis \$100, fair market value \$1,000. Becky owns 100 shares of Y stock, basis \$500, fair market value \$1,000. Under a divorce decree, Becky is ordered to transfer 50 shares of Y stock to Sammy and Sammy is ordered to transfer 50 shares of X to Becky. Under the *Davis* case, each party recognizes a gain on the transfer. The recipient in each case takes a fair market value basis in the stock received. Becky recognizes a gain of \$250 on the transfer of Y, and Sammy's Y basis is increased to \$500. Sammy recognizes a gain of \$450 on his transfer. Becky's basis in X is increased to \$500. There is no change in the basis of the retained stock. Obviously, the tax cost of the division is not equally distributed between Becky and Sammy under *Davis*.

The effect of the bill's carry-over basis principle in this case is to divide the assets and redistribute the bases evenly between the spouses. This result, however, is a purely coincidental division of the tax consequences since each party's stock portfolio now has an aggregate basis of \$300, with a fair market value of \$1,000.

The bill fails to grapple with the realities of property transfer incident to divorce. For instance, consider a situation where Becky owns Whiteacre, basis \$10, fair market value \$100, and trades it with Sammy for Blackacre, basis \$25, fair market value \$100. In this presumed like-kind exchange,¹⁶⁷ where gain or loss goes unrecognized at the time of the exchange, the transferor's basis for the traded property is ordinarily preserved and applied to the property received.¹⁶⁸ (Here, Becky's basis in Blackacre continues to be \$10, her former basis in Whiteacre.) Under the bill, by contrast, the transferor's basis would be grafted onto the property and the gain or loss would travel with the property to its new owner.

The effect of this provision causes one of the most pervasive changes in the treatment of nonrecognition transfers. The effect is a trade, not only of property alone, but of tax consequences as

166. H.R. 4170, 98th Cong., 1st Sess. § 422 (1983) (adds I.R.C. § 1041(b)(2)).

167. It is assumed that the transaction qualifies as a like-kind exchange under I.R.C. § 1031(a) (1982).

168. *But cf.* I.R.C. § 1032 (1982) (transferee corporation takes the transferor's basis).

well. Becky's basis in Blackacre is not \$10 (her basis in Whiteacre), but \$25 (Sammy's basis in Blackacre). If Becky sells Blackacre immediately after the trade, her recognized gain is reduced from \$90 to \$75. Consequently, Becky's tax burden has been partially shifted to Sammy.

The migrating basis can also occur in community property exchanges. Suppose Sammy and Becky own both X and Y stocks as jointly owned or community assets. Sammy receives all of X and Becky receives all of Y. The basis of the property to each spouse will differ, although the fair market value is equal. Before divorce, Becky owned a one-half interest (or \$500 worth) of X, basis \$250. Her potential gain was \$250. Becky also owned \$500 worth of Y, basis \$50. Her potential gain was \$450. After divorce, she owns \$1,000 worth of Y, basis \$100. Her potential gain is \$900, or \$200 greater. The bill does nothing to divide the tax consequences evenly between the parties. This result perpetuates the problem in the current law.

The problem of unequal basis in property acquired in a divorce settlement can have a startling result. As in the original *Davis* case, all the tax on appreciation of assets owned during the marriage can be ascribed to one spouse. Assume still that Sammy and Becky own stocks X and Y jointly or as community property, but that this time, Sammy receives both stocks and pays Becky \$1,000 cash borrowed by pledging the stock. Becky has clearly realized a gain of \$700 on her one-half of the community property. Under current law, the exchange would result in recognition of gain, because it is an exchange of community property for separate property, rather than a division of co-owned property. Under the bill, however, the gain is not recognized.¹⁶⁹ Sammy does not receive a fair market value basis. If he sells both stocks he will recognize the gain on the entire appreciation of the stock. Becky essentially escapes the tax burden. Thus, the problem goes through the looking glass and becomes the mirror image of the *Davis* problem. The bill does not prevent the inequity of a *Davis*-like result—assets are divided but only one spouse carries the tax burden.

A more curious result occurs where Sammy and Becky jointly own all assets during marriage. On divorce, Sammy takes

169. H.R. 4170, 98th Cong. 1st Sess. § 422(a) (1983) (adds I.R.C. § 1041(a)); H. R. REP. No. 432, 98th Cong., 1st Sess. 192 (1983); accord *Technical Memorandum, supra* note 81, at 10.

the assets. This time, Sammy gives Becky his note for \$1,000. Under current law, as the transfer of Becky's community interest in the stock is in exchange for the note (a separate asset), it would result in recognition of gain exactly as it did when Becky received cash. Under the bill, since a transfer incident to divorce does not result in gain or loss, Becky receives the note without recognition of gain or loss. Sammy's basis in his new stock is Becky's old basis. But what is Becky's basis in the note? Under the bill, one possibility is that Becky's basis is Sammy's basis. But what is Sammy's basis? Neither the bill nor the Committee report provides an answer. There are three possible answers. First, it may be argued that since Sammy is the maker of the note, his basis is zero.¹⁷⁰ If a literal interpretation of the bill is applied, Becky's basis upon exchange of her interest in the jointly owned property is zero. It follows then that the entire fair market value¹⁷¹ of the property exchanged will be recognized by Becky. Becky loses the benefit of her original basis. Further, her gain upon payment of the note may be ordinary income.¹⁷² Sammy, on the other hand, receives the benefit of Becky's basis in the previously jointly held property.¹⁷³

Unfortunately, this results in a tax burden much larger than under current law. Becky is taxed at ordinary income rates on the value of the note, while Sammy is taxed at capital gain rates for the difference between the aggregate of his original basis plus Becky's basis and the fair market value of the property.¹⁷⁴

Yet another possible alternative is that Sammy's basis in the note is equal to the basis of the property received.¹⁷⁵ Under this theory, Becky's basis will ricochet to her. In such case, assuming Sammy sells the property at a gain, Sammy and Becky

170. *Cf.* Rev. Rul. 74-503, 1974-2 C.B. 117 (a corporation always has zero basis in its own stock); I.R.C. § 307(b) (1982) (zero basis for certain stock rights elective); I.R.C. § 362(c) (1982) (zero basis for certain capital contributions by nonshareholders); *Fehrs Fin. Co. v. Commissioner*, 487 F.2d 184 (8th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974).

171. In the example, assume Becky is to be a cash method taxpayer. If Becky were an accrual method taxpayer, the face value of the note would constitute the amount realized in the transaction.

172. *See Bingham v. Commissioner*, 105 F.2d 971, 972 (2d Cir. 1939). *Cf. Fairbanks v. United States*, 306 U.S. 436 (1939) (redemption of bonds before maturity and prior to enactment of I.R.C. § 1232 (1982)).

173. H.R. 4170, 98th Cong., 1st Sess. § 422(a) (1983) (adds I.R.C. § 1041(b)(2)).

174. *Id.*

175. *Cf.* I.R.C. § 362(a) (1983) (property acquired by corporation has basis equal to what it would have had in hands of transferor, increased by amount of gain recognized to transferor on such transfer).

each will be taxed on the appreciation of the same asset. In the original *Davis* property settlement, the government avoided this result by setting the wife's basis in the marital rights as the fair market value of the rights at the time of the divorce. Therefore, she did not recognize any gain on the exchange.¹⁷⁶ Under the bill, if it is deemed that Sammy's basis in the note is equal to Becky's basis in her stock, on the sale of the stock and the collection of the note by the respective parties, both parties will recognize gain resulting in double taxation. This result occurs in various nonrecognition transactions.¹⁷⁷

A third alternative is that the note represents a bargained-for exchange. Sammy's basis is that of a purchaser. If Sammy is thus entitled to a cost basis, then it is presumed that both sides of an arm's-length transaction are equal.¹⁷⁸ Hence, Sammy's basis in the note is the fair market value of the property he received in exchange for the note. Becky's basis in the note (derived from Sammy's basis in the note) is the fair market value of the property exchanged. The result of such a principle is that Becky will not recognize a gain on receipt of the note. If this is so, then she has disposed of an asset without recognizing gain. Hence, Sammy is left with the original basis in the property and all the potential tax burden. The same result occurred above when Becky received cash.

The first and second examples result in double taxation. The third result, similar to the *Davis* case, appears to be more plausible. But it too is inconsistent with the intent of the bill. It appears that a simple mechanical application of the proposed carry-over basis rules does not accomplish the sponsor's intent.¹⁷⁹

176. See Rev. Rul. 67-221, 1967-2 C.B. 63.

177. Compare I.R.C. § 1031 (1982) (carry-over basis) with I.R.C. § 362 (1982) (substituted basis) and I.R.C. § 358 (1982) (carry-over basis). In the latter case, the transferor of property to a corporation in exchange for corporate securities takes a carryover basis in the property equal to the former basis in the property transferred, while the corporation takes a substituted basis in the property equal to its transferor's former basis. Hence, if Becky transferred Blackacre, basis \$10 to S Co. in exchange for S Co. stock in a nonrecognition transaction, Becky's basis in her S Co. stock is \$10. S Co.'s basis in Blackacre is also \$10. Although a corporation has a zero basis in its own stock, the substituted basis rule avoids the zero basis problem. Cf. I.R.C. § 1032 (1983) (corporation recognizes no gain on exchange of its stock for property).

178. *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 189 (Ct. Cl. 1954).

179. See H.R. REP. No. 432, 98th Cong., 1st Sess. 191 (1983) (the committee believes it is inappropriate to tax interspousal transfers).

B. Transfer of Assets Subject to Liability

Under the bill, the provisions for automatic nonrecognition and a carry-over basis for transfers between spouses preclude application of the ordinary principles concerning recognition of gain on the transfer of assets subject to tax liability. Assume Sammy owns a farm with a fair market value of \$200, and a basis of \$100. Sammy mortgages it for \$100 cash. He then transfers the farm to Becky. Under the bill, Becky's assumption of the mortgage will not cause recognition of gain to Sammy under *Crane v. Commissioner*.¹⁸⁰ The bill extends the principles applying to equal division of community property to all transfers between spouses.¹⁸¹

Under current law, the transfers of property subject to liability in excess of basis result in a recognition of gain, even in a gift transaction.¹⁸² Under the proposed legislation, the nonrecognition of gain upon a transfer of property where liability exceeds basis may be correct in principle. Yet, one can imagine the potential for tax abuse. Suppose, for example, that Sammy, whose assets are highly appreciated, meets Becky, a prospective buyer, through a personal ad in the financial section of a supermarket tabloid.¹⁸³ Sammy and Becky marry, mortgage the property for close to the fair market value with Aggressive National Bank, and then divide their property equally. Becky receives the asset and Sammy receives the cash. If this scheme is considered a sham,¹⁸⁴ it will not be successful tax-wise. However, if Becky and Sammy's marriage was not a sham, under the bill, the same loan would allow Sammy to bail out cash from the asset tax-free.

Nevertheless, where the amount of liability exceeds the

180. 331 U.S. 1, 4 (1947). See *Technical Memorandum*, *supra* note 81, at 10; H.R. REP. No. 432, 98th Cong., 1st Sess. 192 (1983).

181. Compare Rev. Rul. 76-83, 1976-1 C.B. 213; Rev. Rul. 74-347, 1974-2 C.B. 26, with H.R. REP. No. 432, 98th Cong., 1st Sess. 192 (1983) (the rulings require equal divisions of property to avoid any recognition of gain or loss; the house bill does not require an equitable division to avoid recognition of a gain or loss).

182. *Diedrich v. Commissioner*, 457 U.S. 191, 192 (1982).

183. The author has no personal knowledge of such advertisements, but acknowledges the suggestion by law professor J. David Fine.

184. In *Boyter v. Commissioner*, 668 F.2d 1382 (4th Cir. 1981), an annual divorce ritual was ignored for tax purposes. The Boyters divorced in December and remarried in January of the following year in order to file as single taxpayers. *Id.* at 1384. The court held that the sham transaction doctrine might apply to the Boyter divorce and remanded for such consideration. *Id.* at 1388. Cf. *Knetsch v. United States*, 364 U.S. 361, 366 (1960) (insurance annuity transaction was a sham and did not create an indebtedness that supported the deductions claimed).

basis of an asset, the consequences of gain recognition may produce hardship for many couples who are not seeking to avoid taxes. As an alternative to the initial recommendation of a blanket nonrecognition provision, the Task Force proposed that the recognition of gain be limited to the amount by which the liabilities exceed basis.¹⁸⁵ The Task Force also proposed that the recognition rule be limited in time to encompass only liabilities incurred to facilitate a property settlement in connection with a divorce.

C. Collateral Problems

Additional problems flow from finding that a transfer in a property division is taxable. Losses are not allowed to be recognized in transfers between husband and wife.¹⁸⁶ Under the bill, losses would not be allowed in three instances: transfers which were made during marriage; transfers which were made within one year after the divorce; and, transfers which were related to the divorce.¹⁸⁷ Hence, losses are not recognized even if the transfer takes place after the final decree. Personal losses are not deductible.¹⁸⁸ In addition, the bill deletes certain penalty provisions now applicable to divorce transfers in which gain is recognized.¹⁸⁹

D. Alimony

1. Current Law

Prior to 1942,¹⁹⁰ support payments to a former wife were not

185. Cf. I.R.C. § 357(c) (1982), cited in *Technical Memorandum*, *supra* note 81, at app. II.

186. I.R.C. § 267 (1982); *McWilliams v. Commissioner*, 331 U.S. 694, 699 (1947). See also *Merritt v. Commissioner*, 400 F.2d 417, 421 (5th Cir. 1968) (lack of tax avoidance motive irrelevant).

187. H.R. 4170, 98th Cong., 1st Sess. tit. IV, § 422(a) (1983) (adds I.R.C. § 1041(a), (c)). H.R. REP. No. 432, 98th Cong., 1st Sess. 192 (1983).

188. See I.R.C. §§ 165(c), 262 (1982).

189. See I.R.C. §§ 453(g), 1239 (1982). Further, the Bill fails to address the question of whether interest is imputed to property settlements under I.R.C. § 483 (1982). The Third Circuit, in *Fox v. United States*, 510 F.2d 1330 (3rd Cir. 1975), and the Tax Court in *Gammill v. Commissioner*, 73 T.C. 921 (1980) held that I.R.C. § 483 does not apply to property settlements. But see *Gerlach v. United States*, 74-1 U.S. Tax Cas. (CCH) 9425 (Ct. Cl. 1973) (I.R.C. § 483 applicable to installment payments of taxable property settlement).

190. The predecessor to I.R.C. § 71 (1982) was enacted in the Revenue Act of 1942. The Revenue Act of 1942, Pub. L. No. 753, § 120(a), 56 Stat. 816, 817, added § 22(k) to the Internal Revenue Code of 1939. No substantive changes were made in the 1954 Inter-

deductible.¹⁹¹ When wartime tax rates¹⁹² created pressure for apportionment of income and income tax liability between the former spouses, Congress passed the alimony provisions of the I.R.C. to relieve the husband from the "double burden"¹⁹³ of paying alimony with after-tax dollars. The relief shifted the tax burden to the wife.¹⁹⁴ Alimony is gross income to the recipient¹⁹⁵ and a deduction to determine adjusted gross income for the payor.¹⁹⁶

The current statute creates a divorce premium.¹⁹⁷ Combined with the assignment of income for tax purposes, the single taxpayer or head of household rates usually result in lower overall tax liability compared to filing a joint return. This lower overall rate is problematical. Since the divorced spouses do not form an economic unit, the tax benefit inures to the payor, usually the husband.

Under current law, alimony treatment is determined by whether the transfer is for the support¹⁹⁸ of the recipient or a division of commingled property.¹⁹⁹ Specifically, alimony is

nal Revenue Code. H.R. REP. No. 1337, 83d Cong., 2d Sess. 170, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4025.

191. *Gould v. Gould*, 245 U.S. 157 (1917).

192. Wartime tax rates for taxpayer with an income of \$50,000 rose to 75% in 1944. Peschel, *Income Taxation of Alimony Payments Attributable to Transferred Property: Congressional Confusion*, 44 TUL. L. REV. 223, 225 n.5 (1970).

193. S. REP. No. 1631, 77th Cong., 2d Sess. (1942), *reprinted in* 1942-2 C.B. 504, 568.

194. The sections of the Code taxing alimony divide the income tax burden between former spouses in a manner which is roughly equivalent to filing a joint return prior to divorce. Peschel, *supra* note 192, at 226.

195. I.R.C. § 71 (1982).

196. I.R.C. § 215 (1982).

197. See H.R. REP. No. 432, 98th Cong., 1st Sess. 194 (1983). The report suggests that if A and B have respective incomes of \$50,000 and \$10,000, then their taxes owed in 1983 as single taxpayers are \$14,738 and \$1,121, respectively. The combined tax is \$15,859. If A and B are married, filing jointly the combined tax is \$15,574. If A and B are divorced and A pays B \$20,000 in alimony, they each pay \$6,477. The combined tax is \$12,954. *Id.* Cf. *Druker v. Commissioner*, 697 F.2d 46 (2d Cir. 1982) (marriage penalty is not unconstitutional), *cert. denied*, 103 S. Ct. 2429 (1983).

198. *Smith's Estate v. Commissioner*, 208 F.2d 349, 351 (3d Cir. 1953); *Treas. Reg.* §§ 1.71-1(b)(4), 1.71-1(d)(3)(i)(b) (1960). But see *Mivec v. Commissioner*, 43 T.C.M. (CCH) 24 (1981) (alimony treatment for periodic payments exceeding the wife's pre-divorce interest in marital property).

199. See *Campbell v. Lake*, 220 F.2d 341 (5th Cir. 1955); *Beard v. Commissioner*, 77 T.C. 1275 (1981); *Fisher v. Commissioner*, 37 T.C.M. (CCH) 1851 (1978); *Treas. Reg.* § 1.71-1(b) (1960).

Section 71(a) applies only to payments made because of the family or marital relationship in recognition of the general obligation to support which is made specific by the decree, instrument, or agreement. Thus, section 71(a) does not

defined as a periodic payment,²⁰⁰ received by the wife in discharge of the husband's legal obligation to support,²⁰¹ and incurred under a divorce decree, written separation agreement, or decree for support.²⁰² The periodic payment requirement generally excludes payments of a principle sum²⁰³—one that can be calculated by simple arithmetic—from the definition of alimony. Contingent payments²⁰⁴ and payments made over a period exceeding ten years²⁰⁵ are deemed periodic.

Despite its rigorous requirements, the Code does not distinguish alimony from property settlements. A property settlement under state law may be classified as alimony for federal tax purposes under the current law²⁰⁶ and under the proposed legislative reforms. The potential effect is to change a tax-free distribution into gross income.²⁰⁷ Although in the past a lack of property rights under state law would destroy a wife's claim that payments were a nontaxable property settlement, today virtually every state²⁰⁸ permits or requires a property division on divorce. Because characterization of the payment in dispute is treated as a question of fact, dependent upon both the subjective intent²⁰⁹

apply to that part of any periodic payment which is attributable to the repayment by the husband of, for example, a bona fide loan previously made to him by the wife, the satisfaction of which is specified in the decree, instrument, or agreement as a part of the general settlement between the husband and wife.

Treas. Reg. § 1.71-1(b)(4) (1960).

200. I.R.C. § 71(a) (1982).

201. See *Taylor v. Campbell*, 335 F.2d 841, 845-46 (5th Cir. 1964); *Bardwell v. Commissioner*, 318 F.2d 786, 789 (10th Cir. 1963) (legal obligation of support is independent of state law).

202. See *Brodersen v. Commissioner*, 57 T.C. 412, 415-16 (1971); see also I.R.C. § 71(a) (1982).

203. I.R.C. § 71(c) (1960).

204. *Fidler v. Commissioner*, 231 F.2d 138 (9th Cir. 1956) (the contingency was that payments would be reduced if H lost his job); *Scofield v. Greer*, 185 F.2d 551 (5th Cir. 1950) (payments were to stop in the event of remarriage); *Ryker v. Commissioner*, 33 T.C. 924 (1960) (contingency was remarriage or death); Rev. Rul. 59-190, 1959-1 C.B. 23 (citing Washington law as to death of either party as contingency); Treas. Reg. § 1.71-1(d)(3)(ii)(a) (1960).

205. I.R.C. § 71(c) (1982). See *Wright v. Commissioner*, 543 F.2d 593 (7th Cir. 1976); *Tracy v. Commissioner* 70 T.C. 397 (1978); *Hinish v. Commissioner*, 37 T.C.M. (CCH) 880 (1978) (back rent was periodic payment); *Grabowski v. Commissioner*, 21 T.C.M. (CCH) 249 (1962).

206. *Wright*, 543 F.2d at 593.

207. See generally *Warnach v. Commissioner*, 71 T.C. 541 (1979), *acq.*, 1979-1 C.B. 1.

208. Mississippi does not give property rights to wives. *Bond v. Bond*, 355 So. 2d 672, 673 (Miss. 1978).

209. See *Porter v. Commissioner*, 388 F.2d 670 (6th Cir. 1968). But see *Schotten-*

of the parties and the objective existence of the wife's property rights under state law,²¹⁰ the outcome of such litigation is uncertain.²¹¹ Fact-finding often becomes a "metaphysical"²¹² process as courts search for signs that a challenged payment is "either support or property settlement, when in reality the payment possesses a hybrid nature sharing characteristics of both."²¹³ Since it is usually to the husband's advantage to acquire a tax deduction, many property settlements are cast in the form of alimony payments.²¹⁴ On the other hand, the wife may claim that the payment is excluded from her income as property settlement. The government is caught between the opposing parties. The Task Force proposal addresses the problem.

2. Elective Tax Consequences

The Task Force has proposed amendments to the I.R.C. regulating alimony. First, in the "private ordering" rules,²¹⁵ the divorced parties may explicitly choose tax treatment of divorce-related payments by written agreement.²¹⁶ The Task Force Amendments replace the system whereby tax consequences flow indirectly from transactional forms, such as property settlement, with direct choice of correlative tax consequences by the parties: (a) gross income to the recipient and a deduction for the payor; or (b) no income and no deduction. Additionally, in the absence of such election, the Task Force proposes a mechanical identification process that eases the requirements of alimony. These two contradictory goals, one toward mechanical rules, the other

stein v. Commissioner, 75 T.C. 451, 460-61 (1981) (tangible property rights needed to support taxpayer's claim that receipt was property settlement and not alimony).

210. Wright v. Commissioner, 543 F.2d 593 (7th Cir. 1976).

211. Compare Wright v. Commissioner, 543 F.2d 593 (7th Cir. 1976), with Lambros v. Commissioner, 459 F.2d 69 (6th Cir. 1972).

212. Beard v. Commissioner, 77 T.C. 1275, 1284 (1981).

213. *Id.* See generally Rev. Proc. 82-53, 1982-2 C.B. 842 (service approved clauses for I.R.C. §§ 71 & 215 (1982)).

214. See, e.g., Yoakum v. Commissioner, [Current Regular Decisions] Tax Ct. REP. (CCH) Dec. 40, 950 (1984).

215. See generally *The "Private Ordering" Concept*, *supra* note 80.

216. The term "written agreement" includes an independent written agreement as well as a formal separation agreement whether or not merged into a divorce decree. *Technical Memorandum*, *supra* note 81, at 14. There is some authority that a letter containing a memorandum of a prior oral agreement and not rejected by taxpayer is sufficient to satisfy requirements of a written instrument under current law. See *Osterbauer v. Commissioner*, 43 T.C.M. (CCH) 1364 (1982) (post-divorce modification). But cf. *Dean v. Commissioner*, 42 T.C.M. (CCH) 1237 (1981) (payments made subsequent to divorce under agreement held nondeductible as alimony).

toward direct election by agreement, are characteristic of both the Task Force proposal and the bill. Together, these goals mark a comprehensive plan to simplify the tax treatment of alimony. An important difference between the Task Force proposal and the bill is that the former balances the mechanical rules with the opportunity of direct election.

3. *New Definitions of Alimony*

In lieu of an agreement, the Task Force proposed mechanical rules to determine tax treatment of alimony: cash payments are to be generally considered alimony²¹⁷ while property transfers are not.²¹⁸ Property rights exchanged for cash are excluded from alimony treatment.²¹⁹ An exchange of community assets is treated as a nonrecognition transaction. However, an exchange of marital rights for cash is taxed as ordinary income to the recipient. For the payor, different treatment occurs as well. Where there is an exchange of marital rights for cash, the payor gets a deduction. Where there is an exchange of community assets, the payor does not get a deduction. The occurrence of a cash receipt rather than property is, therefore, crucial to the spouse exchanging marital rights for cash or property and of no significance to the spouse exchanging community property rights for cash or property.²²⁰

The key to the Task Force proposal is a new definition of property rights. Property is defined as including "jointly owned property, individual or community property rights. Marital rights or equitable distribution rights are not property rights."²²¹

217. *Technical Memorandum*, *supra* note 81, at 18.

218. *Id.*

219. *Id.*

220. *Cf.* I.R.C. § 61 (1983); Treas. Reg. § 1.61-1(a) (1954) (gross income does not depend on form of receipt). *But see* Wright v. Commissioner, 543 F.2d 593, 599 (7th Cir. 1976) (form is a factor distinguishing property settlement from alimony payments). The proposal changes current law under which the receipt of cash would not be included in a wife's income nor deductible by a husband if the payment was in exchange for property rights. *See, e.g.*, Biddle v. Commissioner, 38 T.C.M. (CCH) 1361 (1979); Bolza v. Commissioner, 42 T.C.M. (CCH) 1138 (1981); Pierce v. Commissioner, 66 T.C. 840 (1977).

221. *Technical Memorandum*, *supra* note 81, at 7. The proposal ignores the no-fault divorce and equitable distribution statutes adopted by most common-law states. Equitable distribution of property became the handmaiden of no-fault divorce laws adopted in 48 states. UNIF. MAR. PROP. ACT, prefatory note at 3 (1983). All but two of the 40 traditional common-law jurisdictions use property division as a principle means of resolving economic dilemmas on dissolution. *Id.* The legislative changes made by state governments reflected a fundamental change in the American marriage, namely that today most

The Task Force proposal makes an exception to ordinary income treatment of the receipt of cash for marital rights in the case of a " 'special equities' claim—to the extent that under the applicable state law such a claim . . . traces back to genuine *economic* contribution"²²² of the recipient.

4. *An Alternative Definition of Alimony*

Under the bill, as under current law, alimony payments are deductible by the payor and included in the gross income of the recipient.²²³ The bill, however, transforms the process of determining alimony for tax purposes.²²⁴ The current requirement that alimony payments must be periodic, for support, and pursuant to a legal obligation, is eliminated.²²⁵ The bill continues the current requirement that payments must be pursuant to an agreement or decree²²⁶ and adds certain requirements consistent with current law.²²⁷ The parties may designate payments other-

marriages end in divorce. In 1963, 33.69% of total terminations of marriages were by divorce. *Id.* at 2. In contrast, by 1979, for the first time a majority of marriages ended in divorce, 57.23%. *Id.* at 2. Under no-fault divorce statutes, the right to lifetime support is traded for an equitable distribution of property accumulated during the marriage. The proposal would change the tax-free property right to taxable income and thereby diminish the value of the wife's share of the property.

222. *Technical Memorandum, supra* note 81, at 7 (emphasis in original). The aura of simplicity disappears when the exception to the cash rule is applied. It is not merely the lack of a definition of a "genuine *economic* contribution" that causes the problem, but also the premise that wives do not contribute to the accumulation of family wealth. Therefore, a property division in connection with divorce is perceived as a substitute for support and not the liquidation share of a partner. This premise ignores the fact that in over 50% of American marriages, both spouses earn income; in high income marriages (\$24,000 or more) the percentage of two-earner households increases to two-thirds. UNIF. MAR. PROP. ACT, prefatory note at 7 (1983).

223. H.R. 4170, 98th Cong., 1st Sess. § 423(b) (1983) (amends I.R.C. § 215 (1982)) (child support payments are not deductible under current law. Section 423(b) also requires the payor to furnish recipient's social security number).

224. H.R. 4170, 98th Cong., 1st Sess. § 423(a) (1983) (amends I.R.C. § 71(a) (1983)).

225. H. R. REP. No. 432, 98th Cong., 1st Sess. 195 (1983); cf. *Brodersen v. Commissioner*, 57 T.C. 412, 415 (1971) (requirements for alimony under current law).

226. H.R. 4170, 98th Cong., 1st Sess. § 423(a) (1983) (adds I.R.C. §§ 71(b)(2)(A)&(B)).

227. The bill adds the requirement that husband and wife "not be members of the same household" at the time the alimony payment is made. Parties sharing the same residence are not treated as sharing a household if one party is preparing to move out. H. R. REP. No. 432, 98th Cong., 1st Sess. 195 (1983). This codifies the holding in *Sydney v. Commissioner*, 577 F.2d 60, 63 (8th Cir. 1978) and also overturns the Tax Court holding in other circuits. See, e.g., *Hertsch v. Commissioner*, 43 T.C.M. (CCH) 703 (1982); *Washington v. Commissioner*, 77 T.C. 601 (1981). See also *Lyddan v. United States*, 82-1 U.S. TAX CAS. CCH ¶ 9169 (1981), *aff'd*, 721 F.2d 873 (2d Cir. 1983). See *Treas. Reg. § 1.71-1(b)(3)* (1960) (requires parties to be "separated and living apart"). Cf. *Bruch, The*

wise qualifying as alimony as nontaxable.²²⁸ The intent of the bill is generally to treat cash payments as alimony and property transfers as nontaxable. Congress treats "the liability to make any payment for any period following the death"²²⁹ of the recipient as if it were able to isolate this liability as the single trait of a property settlement which only occurs in conjunction with ownership rights, but does not also occur in conjunction with support rights. Thus, a federal definition, independent of state property rights, is attempted.²³⁰ However, either state law or an agreement necessarily must determine the extent of the liability under the decree to make payment following death.

5. Recapture of Alimony Deduction

Under the bill, what is a property settlement under the state law and current tax law may be reclassified as alimony.²³¹ A one-time lump sum payment is partially deductible as alimony. A payment of a principle sum spread evenly over three years is fully deductible. The bill provides a formula for recapture of part of the lump sum payment.²³² Under the bill, if "alimony payments in the first year exceed the average payments in the second and third year by more than \$15,000, the excess amounts are recaptured in the third year."²³³ The payor in such case is required to include the excess in income in the third year. The recipient, who previously included the alimony in income, is

Effect of Informal Marital Separations on Personal Income Taxation, THE TAX ADVISOR 470 (Aug. 1978).

228. H.R. 4170, 98th Cong., 1st Sess. (1983) § 423(a) (adds I.R.C. § 71(b)(1)(B)).

229. H.R. REP. NO. 432, 98th Cong., 1st Sess. 195 (1983).

230. *See id.* at 194 (a uniform federal standard should determine alimony).

231. *But see id.* at 195 (recapture intended to prevent taxing one-time property settlement as alimony). The provision that the exchange of property rights for cash be taxed as alimony is confusing. Converting a property settlement under state law into alimony for federal tax purposes goes against the current trend in state matrimonial and divorce law, and the expectations of most married people that property acquired during the marriage is "ours." UNIF. MAR. PROP. ACT, prefatory note at 9 (1983). This expectation may no longer be an "evanescent hope" but a "reality as a result of provisions of the Uniform Marital Property Act giving spouses a present vested ownership right which each has in all property acquired by the personal efforts of either during the marriage." *Id.* If the uniform act, adopted by the National Conference of Commissioners on Uniform State Laws in July 1983, becomes widely adopted by the states, the distinction between cash and property as an indicia of alimony and property settlement, respectively, will become misleading to the spouse exchanging vested property rights for cash. Under the bill, the effect would be that the cash payment may be taxed as alimony.

232. H.R. 4170, 98th Cong., 1st Sess. § 423(a) (1983) (adds I.R.C. § 71(f)).

233. H.R. REP. NO. 432, 98th Cong., 1st Sess. 195 (1983).

permitted to deduct a like amount.²³⁴ A slightly different formula applies to excess amounts paid in the second year. Recapture applies to the payments in the second year which exceed the payments in the third year by more than \$15,000.²³⁵

Returning to the property settlement where Becky transferred her interest in X Co. (basis \$10,000, fair market value \$100,000) to Sammy for \$100,000 cash, neither Sammy nor Becky recognize a gain under the bill. However, the cash payment may qualify as alimony. If Becky's right to payment ends at her death, under state law, or by agreement between the parties, the lump sum payment will be treated as alimony.²³⁶ As a result, she cannot deduct her basis in the property transferred. The payment is not eligible for capital gains rates.²³⁷ Sammy receives a \$100,000 deduction in year one. If no further payments are made in years two and three, Sammy must recapture the excess alimony deduction. Hence, in year three, Sammy must report his excess deduction taken in year one. Under the rule, \$85,000 is included in Sammy's income and deductible from Becky's income. If the payments instead consisted of \$50,000 paid in year one, \$20,000 paid in year two, and nothing paid in year three, recapture for the second year is \$5,000 (\$20,000 minus \$15,000) plus \$27,500 for year one (\$50,000 minus \$15,000 minus \$7,500). The \$7,500 is the average payments in years two and three after reducing the payments by

234. H.R. 4170, 98th Cong., 1st Sess. § 423(a) (1983) (adds I.R.C. § 71(f)(1)(B)).

235. *Id.* at § 423(a) (adds I.R.C. § 71(f)(4)).

236. In this example, it is assumed that the parties are separated and that the transfer is pursuant to a divorce decree. Presumably an exchange of community property rights for cash would not fit within the definition of alimony because such rights are descendible. It is not clear whether the couple can agree to change the character of the payment to alimony by limiting the payment to the life of the recipient. See *Bolza v. Commissioner*, 42 T.C.M. (CCH) 1138 (1981) (property settlement payments not deductible though made contingent on wife's remarriage). The payor risks an attack on the deductibility of the payment which is alimony only in form. *Cf. Gregory v. Helvering*, 293 U.S. 465 (1935). However, the recipient or his heirs have little risk. "Amounts payable under a life insurance contract on the life of the payee spouse will not be treated as a liability which would affect the status" of alimony payments. H.R. REP. NO. 432, 98th Cong., 1st Sess. 195 (1983). Since the right to support and property are intertwined in the law of most states, at least some portion of a cash payment may reasonably be allocated to alimony. See *Beard v. Commissioner*, 77 T.C. 1275 (1981). The bill's intent to do away with the case-by-case determination of whether a payment is alimony or property settlement is consistent with the purpose of the bill.

237. If the property in this example had depreciated in value, Becky would not be able to recognize a loss on her investment. In addition, her return would be taxed as ordinary income. See I.R.C. § 267 (1982). *Cf. Siewert v. Commissioner*, 72 T.C. 326 (1979).

\$5,000 recaptured from the second year.²³⁸ Hence, the use of a partial alimony deduction for a lump sum payment may reduce Sammy's tax burden. Of course, the price for Sammy's tax relief is paid by Becky. The recapture provision introduces additional complexity to the tax treatment of alimony payments.²³⁹

VI. CHILD SUPPORT: SPOUSE WARS RETURN

Once it is determined that a transfer incident to divorce is either a property settlement or alimony, the couple's tax problems have only just begun. As divorced parents, Sammy and Becky will have continuing tax problems.

A. *The Lester Principle*

Assume Becky has physical custody of the children and Sammy contributes to their support.²⁴⁰ For Becky, the primary question is whether the support payments are included in her income. For Sammy, it is whether the payments are deductible. The indirect and chameleon-like determination of tax conse-

238. H.R. REP. No. 432, 98th Cong., 1st Sess. 196 (1983). Recapture is not required if either party dies or recipient remarries during the three-year period. H.R. 4170, 98th Cong., 1st Sess. § 423(a) (1983) (adds I.R.C. § 71(f)(5)(A)); cf. Rev. Rul. 82-155, 1982-2 C.B. 36. Payments after remarriage of former spouse generally are not deductible by payor as alimony. Differences in state law determine whether payor is legally obligated to pay alimony after recipient's remarriage. See *Schaer v. Commissioner*, 38 T.C.M. (CCH) 1191 (1979) (Pennsylvania law). Alimony payments subsequent to recipient's remarriage are often reclassified as child support. See, e.g., *Henry v. Commissioner*, 44 T.C.M. (CCH) 124 (1982). But see *Blakey v. Commissioner*, 78 T.C. 963 (1982) (alimony payments pursuant to written agreement not contingent on remarriage) (Virginia law). The Commissioner's position is that payments after recipient's remarriage are income to recipient as a windfall under I.R.C. § 61, but are not deductible by payor under I.R.C. § 215 (1982). Rev. Rul. 82-155, 1982-2 C.B. 36 (supersedes Rev. Rul. 81-8, 1981-1 C.B. 42). But see *Colucci v. Commissioner*, 40 T.C.M. (CCH) 499 (1980). Prepayment of alimony prior to the recipient's remarriage normally results in denial of a deduction for the amount paid in excess of monthly installments fixed by the decree of separation. *Moore v. United States*, 449 F. Supp. 163 (N.D. Tex. 1978). *Accord* *Sechrest v. United States*, 490 F.2d 102 (4th Cir.), cert. denied, 419 U.S. 826 (1974); *Van Vlaanderen v. Commissioner*, 175 F.2d 389 (3d Cir. 1949); *Blanchard v. United States*, 424 F. Supp. 916 (D. Md. 1976).

239. The complex provisions concerning recapture cause bunching of income in the year of receipt and are contrary to the bill's aim of simplifying the tax provisions concerning divorce.

240. The bill addresses the relatively minor, but often litigated issue of the dependency exemption. The bill changes the rules for the exemption in two ways. First, generally, the exemption itself goes to the custodial parent unless waived. Second, the bill separates the dependency exemption from the medical expense deduction in the case of children of divorced parents. See *supra* note 155.

quences of the various interpretations of the word "alimony" has its effect upon child support as defined by the federal tax law.

The tax principles governing child support payments can be stated simply. Child support is neither gross income to the recipient²⁴¹ nor deductible by the payor.²⁴² It has the status of a nontaxable transfer. Consider a separation agreement similar to that construed by the Supreme Court in *Commissioner v. Lester*.²⁴³ Sammy pays a total of \$600 per month toward the support of Becky and their three children. However, as each of the three children cease to be dependent, the payment is reduced by one-sixth of the amount, \$100. Here, Becky understands that the payment is 50 % alimony and 50 % child support. But the tax consequences are not apportioned as \$300 alimony and \$300 child support. Sammy's total payment of \$600 is alimony.²⁴⁴ Although simple arithmetic could establish how much of the payment is child support, the Supreme Court held in *Lester* that such wording is insufficient to fix "any specific amount or portion" of the payments as child support.²⁴⁵ The trick is to determine whether a given payment falls within the category of child support.²⁴⁶

Under the *Lester* principle, a payment combining support for both the wife and the children is classified as alimony.²⁴⁷

241. I.R.C. § 71(b) (1982). An amount of money or a part of the payment fixed as child support by the terms of the divorce decree or agreement is not alimony income to the recipient. *Id.* See also I.R.C. §§ 61(a)(8), 682(a) (1982) (child support payments from trust not income to the recipient).

242. Payments to former spouse are deductible only if included in recipient's income under I.R.C. § 71 (1982). See I.R.C. § 215 (1982). In the case of part payment of alimony and child support, funds are first applied to child support. I.R.C. § 71(b) (1982). For example, Sammy is required by a divorce decree to pay Becky \$12,000 per year in alimony and \$12,000 per year in child support. Sammy pays \$15,000 in 1983. Only the \$3,000 paid in excess of child support is deductible as alimony. If Sammy paid \$11,000 in 1983, the full amount is allocated to child support and nothing is deductible as alimony. See Treas. Reg. § 1.71-1(e) (1960). See also *Ross v. Commissioner*, 31 T.C.M. (CCH) 488 (1972).

243. 366 U.S. 299 (1961).

244. *Id.*

245. *Id.* at 300.

246. The *Lester* language implies that wives, such as Becky, are taxed on their receipt of support as alimony because the money is subject to their "unfettered command." *Lester*, 366 U.S. at 303. This language is deceptive, however, because no case indicates that Becky must account for child support, see *Maytag v. Commissioner*, 370 F.2d 914 (10th Cir. 1966), cert. denied, 386 U.S. 1034 (1967), or use the payments for the children. *Id.* Becky must neither prove nor itemize any expenditures on behalf of the children. *Id.*

247. *Lester*, 366 U.S. 299. Indirect payments such as medical insurance coverage for

Child support is not to be inferred from the language of the decree.²⁴⁸ For example, a decree stating that the purpose of the payment to Becky is to take care of the children²⁴⁹ does not transform alimony into child support. Nor does the fact that the entire sum is spent on the children fix the payment as child support.²⁵⁰ The words required by *Lester* to isolate alimony or child support with their respective consequent tax status are words of designation, not obligation.²⁵¹ A willful shift in the ordinary tax liabilities of support payments from Becky back to Sammy is required.²⁵² The rule is not neutral between the parties to the divorce. Where the parties do not have tax advice or the agreement is poorly drafted, the *Lester* rule tends to place tax liability on the custodial parent.²⁵³ Even in states such as Washington which have adopted minimum child support guidelines,²⁵⁴ the

both wife and children will be treated as alimony unless the amount of the children's coverage is separately stated. Thus, a single premium paid for coverage of wife and children is taxed as alimony, not child support. *Levine v. Commissioner*, 26 T.C.M. (CCH) 531 (1967).

248. *Lester*, 366 U.S. at 303.

249. *Taylor v. Taylor*, 349 F. Supp. 123, 124 (W.D. Va. 1972) (mere intent not sufficient).

250. *Hummel v. Commissioner*, 28 T.C. 1131 (1957). *But see* *Sperling v. Commissioner*, 45 T.C.M. (CCH) 193 (1982), *aff'd*, 84-1 U.S. Tax Cas. (CCH) ¶ 9176 (2d Cir. 1984) (children's college expenses paid pursuant to separation agreement not alimony).

251. Once the boundary line separating alimony from child support is crossed, child support payments do not become alimony by the fact that Becky puts all her child support payments in the bank. Nor are they changed by the fact that Becky is not legally obligated to spend the money on the children, *West v. United States*, 413 F.2d 294, 295 (4th Cir. 1969), or by the fact that the child for whom support has been fixed is over 18 and not legally a minor. *Borbonus v. Commissioner*, 42 T.C. 983 (1964) (minor defined as one under 21).

252. The pitfalls of the *Lester* case can be avoided with careful drafting of the divorce decree or separation agreement. The use of different paragraphs and subtitles clearly distinguishes child support from alimony provisions. The net cost of child support depends upon the taxable income of the payor. *See infra* notes 257-59 and accompanying text.

253. Various studies report that approximately 90% of children of divorced parents live with their mother. *See, e.g.,* Bruch, *Developing Standards for Child Support Payments: A Critique of Current Practice*, 16 U.C.D. L. REV. 49, 53 n.17 (1982). The divorced woman experiences a greater economic decline than the divorced man. Studies of families with young children showed mothers experienced very rapid economic decline. For couples married less than 10 years and having a low per capita income level (less than \$20,000 per year), the husband's post-divorce income was twice that of his wife. At higher income levels (over \$40,000), the husband had 200% of his pre-divorce income, while the wife had only 48%. Weitzman, *The Economics of Divorce: Social and Economic Consequences of Property, Alimony and Child Support Awards*, 28 U.C.L.A. L. REV. 1181, 1244 (1981); *cf. id.* at 1239, 1248.

254. Family Law Section of Seattle King County Bar Association, *New Child Support Schedule Dissolved Marriages*, SEATTLE KING COUNTY BAR BULL. 1 (Dec. 1974) p.1.

wording of the decree may fall within the holding of *Lester* and be taxed as alimony.²⁵⁵ The support ordered by the state court is thereby indirectly modified by an unexpected shift of the tax burden.²⁵⁶ The federal court deciding the tax issue does not have jurisdiction to restructure the divorce decree.

The basis for the *Lester* policy is the belief that Sammy's ability to shift that tax burden to Becky will benefit the former family group by a correlative increase in tax deductible support payments. In theory, Sammy reduces his taxable income by shifting the tax burden for child support to Becky. In the ideal example, Becky's tax bracket is increased and Sammy's is decreased until a point of equilibrium is reached.²⁵⁷ The total tax calculated by combining the tax liability of high and low bracket taxpayers is higher than combining the tax liability of two middle range taxpayers.²⁵⁸

The fallacy of the *Lester* principle is in the combination. Sammy and Becky are no longer an economic unit. The shift in the tax consequences to Becky means Becky pays more tax while Sammy pays less.²⁵⁹ Sammy may be content to pay tax on his

255. *Stevens v. Commissioner*, 44 T.C.M. (CCH) 220 (1982), *aff'd*, 709 F.2d 12 (5th Cir. 1983).

256. *Cf. Newman v. Commissioner*, 33 T.C.M. (CCH) 219 (1974) (wife's alimony reduced on basis that it was not taxable income).

257. Sammy and Becky are divorced parents with taxable incomes of \$50,000 and \$10,000 respectively. Sammy files as a single taxpayer and Becky files as head of household. If Sammy pays Becky \$20,000 in alimony, each has taxable income of \$30,000. Sammy and Becky pay tax of \$6,486 and \$5,951, respectively, or a combined tax of \$12,437. The tax is not equal because the filing status of the custodial parent as head of household has a lower rate than the status of the noncustodial parent filing as a single taxpayer. See *Blumenthal v. Commissioner*, [Current Memo Decisions] TAX CT. REP. (CCH) Dec. 40,662(m) (1983). In this example the spread between the lowest and highest marginal rates is so great that in order to achieve equilibrium an inordinate sum would have to change hands. See Weitzman, *supra* note 253, at 1243, 1249. Where the spouses have comparable income, there is no tax advantage overall in the use of alimony to shift income between former spouses.

258. Sammy and Becky are divorced parents with taxable incomes of \$50,000 and \$10,000 respectively. Sammy files as a single taxpayer and Becky files as head of household. Sammy pays a tax of \$14,738. Becky pays a tax of \$1,073. The combined tax is \$15,811. The tax liability of this combination of high and low income bracket taxpayers exceeds the combination of middle range taxpayers in the example above by \$3,374. See *supra* note 195.

259. Sammy's taxable income is \$50,000 and Becky's taxable income is \$10,000. Sammy pays Becky \$10,000. If the transfer is labeled alimony, Sammy's income is reduced to \$40,000. Sammy's tax on \$40,000 is \$10,323. This is \$4,415 less than if his income remained at \$50,000 (\$14,738). His net cost is \$5,585 (\$10,000 transfer less \$4,415 tax saving). This transfer also causes Becky's income to increase to \$20,000. Her tax on \$20,000 is \$3,128. This represents an increase in tax of \$2,055 over the amount of tax

high income and give Becky the minimum amount of support.²⁶⁰

B. The Lester Principle—A Faded Line

I.R.C. section 71(b)²⁶¹ has been interpreted as an election between taxable and nontaxable support payments.²⁶² Since the election is not made directly, often the tax consequences of the payment are not those intended. The *Lester* principle is difficult to apply because the mechanical construction in favor of alimony thwarts the taxpayers' common sense expectation. Where a sum is not sufficiently identified as child support, parol evidence is not permitted to show the intent to designate the payment as child support.²⁶³ In turn, a divorce decree that does not pass the *Lester* requirements in federal court often leads to renewed state court litigation to amend the decree. In the case of a mistake, a *nunc pro tunc* order in state court can apportion child support retroactively²⁶⁴ or prospectively.²⁶⁵ This solution requires unnecessary and costly litigation at the state level.

Some lower courts have softened the *Lester* principle where circumstances include a conscious delineation between alimony and child support. For example, although the sentence, "The sum shall be reduced by \$7,000 as each child reaches majority" does not fix an amount of child support,²⁶⁶ the mere addition of

paid on \$10,000 (\$1,073). Her net receipt is \$7,945 (\$10,000 transfer less \$2,055 tax increase). If the same payment is labeled child support, neither Sammy's nor Becky's income is changed by the transfer. The cost to Sammy is the \$10,000 transfer plus \$4,415 in tax. Becky nets the full \$10,000.

260. In practice, child support awards rarely meet a child's minimal needs or assure the child a standard of living comparable to that of the noncustodial parent. Bruch, *supra* note 253, at 50.

261. I.R.C. § 71(b) (1982).

262. The "Private Ordering" Concept, *supra* note 80, at 6.

263. Metcalf v. Commissioner, 343 F.2d 66, 67-68 (1st Cir. 1965); see also Newman v. Commissioner, 42 T.C.M. (CCH) 1522, 1523-24 (1981); Cothman v. Commissioner, 57 T.C. 296, 300-01 (1971). But see Westreich v. Commissioner, 36 T.C.M. (CCH) 1563, 1565 (1977); Cohen v. Commissioner, 36 T.C.M. (CCH) 1559, 1562 (1977) (companion cases); Johnson v. Commissioner, 45 T.C. 530, 532-33 (1966) (parol evidence fixed child support where decree failed *Lester* test).

264. See, e.g., Muss v. Commissioner, 29 T.C.M. (CCH) 758, 760 (1970) (amended order conformed to judge's original intent). Retroactivity for tax purposes is generally limited to clerical errors. See Johnson v. Commissioner, 45 T.C. 530, 532-33 (1966); Rev. Rul. 71-416, 1971-2 C.B. 83.

265. Graham v. Commissioner, 79 T.C. 415, 423 (1982); Gordon v. Commissioner, 70 T.C. 525, 533 (1978) (retroactive change in legal status of payments not given retroactive effect for tax purposes); Rev. Rul. 58-52, 1958-1 C.B. 29.

266. See *Lester*, 376 U.S. at 300. See also Rev. Proc. 82-53, 1982-2 C.B. 842 (forms for taxable or nontaxable support payments).

the words "for tax purpose"²⁶⁷ or "wife undertakes to expend at least \$30 per week of the alimony for the benefit of the children"²⁶⁸ or "binding the estate of husband to the extent of \$4,000 for the benefit of the children"²⁶⁹ has been held to fix such amounts as child support. The cumulative result is that these lower court decisions overrun the supposedly clear distinction between taxable or nontaxable payments posed by the *Lester* case as if it were the Maginot Line.

C. *Reforming Alimony and Child Support Taxation*

The Task Force proposals would change the choice of names to "includible/deductible" (alimony) and "nonincludible/nondeductible" (child support).²⁷⁰ For couples reaching an agreement, any amount chosen, whether characterized as child support or alimony under current law, could be designated as includible income to the recipient and deductible by the payor.²⁷¹ For example, by written agreement, Sammy pays Becky \$1,000 per month, 40% to be specified as includible/deductible, 60% nonincludible/nondeductible. Under the proposal, the allocation of income tax would bind the parties and the Government.²⁷² Where the parties do not choose the private ordering rules, the current rules under I.R.C. section 71(b) and the *Lester* case will continue as "fall back rules."²⁷³ Although the private ordering proposal should end much of the litigation, the fall back rules will perpetuate the problems with applying *Lester*.

The Task Force proposal to change the terminology from "alimony" and "child support" to "deductible" and "nondeductible," though a great leap forward, does not answer certain questions. If deductible payments are elected, does the election continue as long as payments are made, or will certain contingencies cause the deduction to end? A similar problem results under the bill. Under both proposals, alimony treatment is no longer predicated upon the payment being pursuant to a legal obligation to

267. *Abramo v. Commissioner*, 78 T.C. 154, 157 (1982).

268. *West v. United States*, 413 F.2d 294 (4th Cir. 1969).

269. *Commissioner v. Gotthelf*, 407 F.2d 491, 493 (2d Cir.), *cert. denied*, 396 U.S. 828 (1969).

270. *Technical Memorandum*, *supra* note 81, at 12.

271. *Id.*

272. See *The "Private Ordering" Concept*, *supra* note 80, at 2-5.

273. *Technical Memorandum*, *supra* note 81, at 19.

support the former spouse.²⁷⁴ Hence, it is unclear whether the right to a deduction will end in the case of remarriage of the recipient.

Consider that Sammy and Becky agree that 80% of the \$1,000 per month that Sammy pays to Becky will be taxed as alimony. The payment will be for fifteen years. Their youngest child is six. Becky remarries and Sammy continues to pay the \$1,000 to support the children. Will Sammy's payment continue to be deductible? The current federal tax law follows the usual state law practice of ending alimony rights at remarriage. In such case payments after remarriage are not pursuant to the requisite legal obligation and hence not deductible as alimony. Therefore, Sammy loses his \$800 deduction upon remarriage unless state law will enforce an agreement to pay alimony after the recipient's remarriage. The concept of alimony under state family law, based on support rights, does not relate to the bill's definition of alimony under the federal tax law (cash payments contingent upon recipient's death). Therefore, under the bill, the answer to whether Sammy may shift the tax incidence of support payments to Becky can no longer be answered by reference to state law. However, the language of both the bill and the Task Force proposal support a continuing deduction for Sammy.²⁷⁵ If the alimony deduction continues after Becky's

274. H.R. REP. NO. 432, 98th Cong., 1st Sess. 195 (1983).

275. Under current law, this question is answered by reference to state law. Where state law terminates support rights upon the recipient's remarriage, purported alimony payments made after the former spouse's remarriage generally are not deductible. See *Hoffman v. Commissioner*, 54 T.C. 1607, 1611 (1970), *aff'd per curiam*, 455 F.2d 161 (7th Cir. 1972); *Cohen v. Commissioner*, 36 T.C.M. (CCH) 1559, 1562 (1977); *Joss v. Commissioner*, 56 T.C. 378, 384 (1971); *Brown v. Commissioner*, 50 T.C. 865, 871 (1968), *aff'd per curiam*, 415 F.2d 310 (4th Cir. 1969); Rev. Rul. 82-155, 1982-2 C.B. 36, 37 (amplifying and superceding Rev. Rul. 81-8, 1981-1 C.B. 42). Nevertheless, payments may be income to the recipient unless excluded by another section of the Code. *Id.* at 37. In the minority of states where the recipient's remarriage does not affect alimony rights under state law, the tax status of the payment as alimony does not change. *Hayutin v. Commissioner*, 508 F.2d 462 (10th Cir. 1974) (payments extended over more than 10-year period); *Guiberson v. United States*, 43 A.F.T.R.2d (P-H) ¶ 79-352 (D. Kan. 1978) (payments under the decree did not end on remarriage absent a provision in the settlement, alimony terminated only on death of husband under state law). Two rules have developed with respect to the tax status of alimony payments that serve as support for children as well as for the former wife and which are to continue after the wife's remarriage. One rule is that alimony is reclassified as child support when the wife in fact remarries. The other rule is that alimony payments continue despite remarriage. *Henry v. Commissioner*, 44 T.C.M. (CCH) 124, 127 (1982) (payments after former spouse's remarriage reclassified as child support under Georgia law); *Westreich v. Commissioner*, 36 T.C.M. (CCH) 1563 (1977); *Toole v. Commissioner*, 33 T.C.M. (CCH) 1304 (1974); see *Wilson v. Commissioner*, 49

remarriage, Sammy, as a divorced, noncustodial father, will be in a better tax position after the divorce than before the divorce when contributions to child support were not deductible.²⁷⁶ This is poor tax policy.

At a time when child support payments tend to be based on minimum standards, the *Lester* principle places the tax burden on the former spouse with the lower standard of living without compensating for the tax cost of the payment. If this happens, there is less support for the child. The *Lester* principle is not in reality a source of flexibility for the taxpayer. The divorcing couple should have a direct and informed choice regarding which of them bears the tax burden of child support.²⁷⁷ The *Lester* principle has sired the practice of overreaching by the party with tax advice against the custodial parent. "Accordingly the practice of '*Lesterizing*' child-support payments—i.e., '*burying*' them under spousal support labels solely for tax purposes—is extremely common today."²⁷⁸ Congress should not ratify this subterfuge.

The sources used by the Task Force include the 1942 testimony of Randolph Paul²⁷⁹ that in some cases the "entire income" of the husband was absorbed by taxes and alimony. Paul added, "At the same time, divorced wives receiving tax free alimony possess a privileged status under our tax laws which relieves them of any share of the tax burden."²⁸⁰ This view is hardly in accord with current studies of the standard of living of divorced women and their children.

VII. CONCLUSION

There are two questions associated with the taxation of property divisions. The first is how to limit the impact of the federal tax law on state-created marital rights. The second is

T.C. 1 (1967); see also *Engelhardt v. Commissioner*, 58 T.C. 641 (1972). Before the remarriage the requirement that payments continue upon remarriage does not affect alimony treatment. *Isaacson v. Commissioner*, 58 T.C. 658 (1972).

276. Becky's status as a remarried recipient of alimony will allow her to file a joint return with her second husband, and also allow her first husband to continue to split his income with her. This is a departure from the classic doctrine against assignment of income. See *Lucas v. Earl*, 281 U.S. 111 (1930).

277. Compare I.R.C. § 215 (1982) (alimony deduction) with I.R.C. § 44a (1982) (child care credit).

278. *The "Private Ordering" Concept*, supra note 80, at 6.

279. *The "Private Ordering" Concept*, supra note 80, Exhibit B, Item 1.

280. *Id.*

how to achieve equity in the division of property and support obligations between the former spouses. Congress and the ABA Task Force answer these questions with markedly different approaches. The author summarizes these approaches in the charts following this article.

The economic apportionment of property is determined ordinarily by private agreement sanctioned by the state divorce court. In amending the Code sections taxing divorce-related transfers, Congress should weigh the impact that the federal tax law reapportionment of the division has on the legitimate interests of the state government and the divorced taxpayer. If the goal of the legislative reform is to produce uniform tax results despite differences in state law, a unified federal system seems to be the way to achieve it. On the other hand, such a standard may not be attainable under a federal system. If it were, the question becomes whether the federal government, through the tax law, should control property settlement.

Establishing a body of substantive law for federal courts in matters not otherwise of federal concern is not a legitimate end within the scope of the constitution; thus, to frustrate the ability of the states to make their laws fully effective in areas generally reserved to them would be inconsistent with the constitutional plan.²⁸¹

In practice, the second question is answered in the negotiation process determining the property settlement agreement. Ninety percent²⁸² of domestic relations cases are settled by agreement rather than by court decree. The only aspect of the divorce that cannot be settled by agreement is the apportionment of the tax burden between the former spouses. The private ordering concept of the Task Force proposal is a fair and rational way to determine tax disputes.

Making the parties take tax positions consistent with their agreement is good policy. The policy should be expanded to make apportionment of tax consequences by the divorce decree binding in the same manner as private ordering agreements. Without private ordering, the economics of a divorce settlement

281. Friendly, *In Praise of Erie and the New Federal Common Law*, 39 N.Y.U. L. Rev. 383, 397 (1964).

282. *The "Private Ordering" Concept*, *supra* note 80, at 9 (citing Mnookin & Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L. J. 950, 951 n.3 (1979) (less than 10% of divorces are contested)).

cannot be fully certain. The direct election of tax results by the former spouses prevents the mechanical rules, initiated as safe harbors, from applying in an arbitrary way.²⁸³

Sammy and Becky deserve fewer, not more troubles, as they endure the stress of their divorce. It is unworthy of the federal government to permit the quarrel that ended in the divorce court to be revived in a tax proceeding forum.

[EDITOR'S NOTE: At the time of publication, H.R. 4170 (now the Tax Reform Act of 1984) was amended and approved by the House Ways and Means Committee and is now pending before Congress.]

283. Reform of the taxation of property transfers incident to divorce should include the following measures: (1) permit direct election of tax consequences of property division whereby the parties can choose either a nontaxable property division with a carry-over basis or a taxable property division with a stepped-up basis, *see supra* notes 158-60 and accompanying text; (2) permit nontaxable cash transfers to facilitate equal property divisions, *see supra* notes 152-53 and accompanying text; (3) adopt different basis rules consistent with either an in-kind division of property or an exchange of separate property, *see supra* notes 150-54 and accompanying text; and, (4) limit the tax-free transfer of property subject to liability in excess of basis, *see supra* note 185 and accompanying text.

CHART 1

Types of Property Division	Property Settlement Under Current Law		
	Tax Consequences	To Recipient	Basis to Recipient
1. Settlement of wife's right of support	gain/loss recognition* under §1001; if payments are periodic then deduction for alimony under §215	if payments of property are periodic, transfer results in alimony income under §71(a).	fair market value at date of transfer
2. Settlement of wife's inchoate right such as dower or equitable apportionment where wife has no species of co-ownership	gain/loss recognized* no deduction for payment	not taxed as alimony even if payments are periodic	fair market value at date of transfer
3. Equal partition of joint or commonly held property including community property	no gain or loss recognized no deduction for payment	not taxed as alimony even if payments are periodic	one-half of pre-divorce basis (carry-over basis)
4. Unequal partition of community property	to extent of division of community assets, no gain or loss. Party transferring more than one-half of community property will recognize a ratable portion of gain or loss in proportion to separate property received. If transfer classed as alimony and payments are periodic, deduction available under §215.	if part of transfer is for support and payments are periodic, they are taxed as alimony under §71(a).	if tracing is possible, those assets exchanged for community assets treated as 3 above; those assets exchanged for separate property treated as 1 and 2 above. If tracing impossible, no case prescribes appropriate allocation.

*loss will not be recognized if either I.R.C. section 165 or 267 apply.

CHART 2
Property Settlement Under H.R. 4170

Types of Property Division	Tax Consequences		Basis To Recipient
	To Transferor	To Recipient	
1. Settlement of wife's right of support	If property transferred not treated as alimony, no recognition of gain/loss under §1001; if payments are cash, and payor not obligated to pay after death of recipient, then deduction for alimony under §215 which may be subject to recapture.	If payments are in-kind, then no income; if payments are cash and end on death of recipient, transfer results in alimony income under §71(a).	transferor's pre-divorce basis in the property.
2. Settlement of wife's inchoate right such as dower or equitable apportionment where wife has no species of co-ownership	Same as above.	Same as above.	Same as above.
3. Equal partition of jointly or commonly held property including community property	Same as above.	Same as above.	one-half of original predivorce basis.
4. Unequal partition of community property	Same as above.	Same as above.	Same as 1 above.